



Exit Planning Information & Education for America's Business Owners

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PROVIDED BY:



**Weatherby & Associates, PC**  
Counselors at Law

Helping Families Preserve and Protect Assets and Values

Issue 6

**Transferring the Business to Children or Employees: A Recipe for Disaster?**  
(Step Five)

*This issue is provided to you by Weatherby & Associates, PC Attorney, Hank Weatherby.*

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How do you successfully transfer your business to a child, key employee or co-owner? The most successful method is to follow a recipe that mixes, in equal measure, three key ingredients:

- I One part: the ability, experience and dedication of the prospective new owners;
- I One part: a company with strong, consistent cash flow and little debt; and
- I One part: a transaction designed to prevent income taxes from eroding the cash flow available to you, the seller.

It should be obvious that a business cannot be successfully transferred unless the new ownership is capable, nor can we expect the transfer to be successful if the business itself lacks the ability to provide an ongoing stream of income with which to pay for the business acquisition. What may not be so obvious; however, is the corrosive affect of income taxation upon the transfer of a business to "insiders" — children, key employees or co-owners. Let's look at two key facts associated with transferring business to an insider.

*First, your children or key employees may not have cash to buy you out. Therefore, any sale may take many years to complete — a potentially risky prospect. Further, all of the cash used to purchase your ownership may come from one source: the future cash flow of the business after you have left it.*

Second, without planning, the cash flow can be taxed twice. It is this double tax, (sometimes totaling more than 50 percent) that can spell disaster for many internal transfers. Through effective tax planning, however, much of this tax burden can be legally avoided. Witness what Karl Clark did.

*Karl Clark agreed to sell his company to a key employee, Sharon Smith, for \$1*

*million. This value was based on the company's annual \$250,000 cash flow, which Karl historically took in the form of salary. While Karl understood that Sharon could not pay \$1 million (nor could she secure financing), he did think that she could buy out the company over a five- or six-year period, using the available cash flow of the company.*

*Karl's calculations were way off the mark. The time needed for a buy out was at least 10 years. But why were his calculations so off base? In a word, taxes — actually in two words, double taxation. Without proper planning, this is what happens if Sharon buys the company (and what can happen to you when you attempt to sell your business to your children or employees):*

1. *Sharon receives the cash flow (\$250,000 per year) and is taxed on it at a combined federal and state tax rate of 40 percent (These rates may vary dependent on total income and your state's tax rate).*
2. *Sharon pays \$100,000 in taxes (40 percent of \$250,000). This is the first tax on the business's cash flow.*
3. *Sharon pays the remaining \$150,000 (net after tax) to Karl.*
4. *Karl pays a 20 percent capital gains tax on the \$150,000 he has received for the sale of his ownership interest, or \$30,000 in taxes. This is the second tax on the original stream of income from the business. The result?*
5. *The company distributed \$250,000 of its cash flow, but Karl was only able to put \$120,000 in his pocket.*

**Without proper tax planning, you too may experience an effective tax rate that could be excess of 50 percent on the company's available cash flow used to fund your buyout.** This is likely to prevent, as it did for Karl and Sharon, a consummation of the sale of the business.

How might you avoid disaster and design your sale to minimize taxes and maximize the opportunity for success?

1. Plan. Like Karl, you should have a plan that yields you a greater after-tax amount for the sale of your company. Since the cash flow of the company may likely increase, the key is to provide Uncle Sam a smaller slice of the available cash flow.
2. Use an experienced advisory team, usually consisting of a business attorney, CPA and insurance or financial professional. They should understand the importance of tax sensitivity to both seller *and* buyer in order to make more money available to you.
3. In addition, you and your advisors should use a modest, but defensible valuation for the company. Because a lower value is used for the purchase price, the size of the tax bite is correspondingly reduced. The difference between what you will receive from the sale of your business, at a lower price, and what you want to be paid to you after you leave the business is "made good" through a number of different techniques to extract cash from the company after you leave it.

Tax planning for the transfer of your company to an insider takes time, it takes planning, it takes knowledge, but it can possibly save a tremendous amount of money. Take time now to begin the planning process.

- I Learn as much as you can about how to best accomplish the transfer of your business.
- I Seek the advice of your advisory team sooner rather than later.
- I Act sooner rather than later. Taking action sooner rather than later may help your business transfer recipe provide a tastier result. Bon appetit!

*Subsequent issues of **The Exit Planning Review**<sup>™</sup> discuss all aspects of Exit Planning. The provider of this Newsletter ([Hank Weatherby](#)) offer you unbiased information about what you may need to know — How To Run Your Business*

*So You Can Leave It In Style™.*

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