THE PRIVATELY HELD BUSINESS

PRE-LIQUIDITY PLANNING: BEFORE YOU SELL THAT BUSINESS

Pre-liquidity planning

"Start with the end goal in mind." It's an important prerequisite if you own a business and are laying the groundwork for selling it in a few years. But it's not just about detailed planning for the business—your sale timeline can greatly affect your personal wealth planning goals. The same is true if you're not the business owner but hold a significant equity stake.

In the course of a given year, thousands of private business owners sell their companies. If you expect to be among that number soon, you won't be alone: A study done by Pepperdine University found that 70% of business owners plan to transfer their ownership interests in the next decade.[1]

Business owners decide to sell for all sorts of reasons. Sometimes they want to retire, monetize their asset and start a new chapter. Alternatively, there may be no one to pass the business on to, perhaps due to lack of interest or qualifications of family members or lack of a successor altogether. Or, the owner may simply be looking to diversify. No matter the reason, business owners tend to want to transition the business on their own timetable and on their own terms. Planning well in advance of a sale makes the best sense. The business itself needs to be well positioned for sale and the owner needs to prepare for wealth transformation and take advantage of planning strategies for wealth transfer and charitable giving. "The earlier you plan, the bigger the opportunity set for your personal and family goals," says Caroline McKay, senior wealth strategist for CIBC Private Wealth. "We've had clients come to us just a month before the sale of a business and, while there are tactics we can help implement, they are far more limited than if we have a year or more. And if you hold an equity stake in a privately held business, you may not have much advance warning that you're going to experience a liquidity event—the sale, after all, is not in your hands."

For either situation, two words are critical: presale strategy. Tax planning, of course, is an essential component of a presale strategy. "A very thorough analysis before you sell can help you understand both the income tax and estate planning implications," says McKay. "We also want to have discussions about your investment strategy post-sale. If you've been living on the income from your business, we'll want to talk about a strategy for using the proceeds from a liquidity event for an investment portfolio that may need to last many years. There are many issues to consider when you're preparing for liquidity, and it's easy to see how a business owner's own planning can fall through the cracks. They're often very busy wearing two hats—running the business and seeing the sale process through to conclusion."

Position your business for maximum value

Why do you want to sell? And to whom?

Every business owner thinking about an exit strategy should also think carefully about his or her long-term goals, says Michael Y. Lateef, a partner with the Hanson Bridgett law firm in San Francisco. "That's very different from your exit strategy being 'continue to grow the company and see what comes along.' The strategy for the best results—for both businesses and owners—is to ask what to do to prepare for either outcome: a planned sale or an unexpected offer. The first question we ask an owner is: 'Whom would you sell to?' If the answer is 'I don't know, but I know my industry contacts, and I'll get the word out there,' we advise him or her to think more strategically. As a seller, you need to work on things that can make the company as attractive as possible. Much of that is internal work to get maximum value for the company."

Lateef says that "positioning" steps generally fall into the following areas:

- **Clean up the financial statements.** In privately held businesses, expenses often are run through the business that really should not be, or loans to family members or other owners have never been paid back. Review your financials for these situations and resolve them. Get your receivables as current as possible. Financial statements should be current and, to the extent possible, prepared in accordance with Generally Accepted Accounting Principles (GAAP). Determine whether it's reasonable to have your financial statements audited by an accounting firm or, if auditing is too time consuming and expensive, have your financials reviewed by an accounting firm.

- **Verify that all human resource and hiring documents are up to date**. Review with counsel all of your employment and consulting agreements, intellectual property agreements, and confidentiality and noncompete/restrictive agreements. The business may need to secure agreements with essential employees and key management. Documents on intellectual property (IP) are particularly important, says Lateef. "In a work-for-hire state, whatever employees develop for your company belongs to the company. The same is not true for independent contractors—make sure you have the appropriate IP assignment provisions in writing. In addition, be aware that provisions you may have for nonsolicitation or noncompete after an employee leaves may be void in many states as a matter of public policy, unless they are narrowly tailored to allow a company to properly protect their trade secrets and proprietary information."

- **Review other contractual arrangements**. Are there valuable strategic alliances and long-term contracts with suppliers or vendors? If so, you would be well advised to have those relationships locked down in writing. If the business requires real estate to operate, are long-term leases in place? If you're the business founder, review your own documents for change-of-control incentives and requirements for staying with the company after it's sold.

- **Improve corporate governance**. While sometimes lax in privately held businesses, good corporate governance is essential today—and to be in the best position, your governing documents shouldn't come from free or low-cost online sites where you can simply download documents. Nor should you rely on free articles of incorporation from your Secretary of State's office. "Really good governing documents take into account a lot of complexity that may show up in the due diligence process when you're ready to sell," says Lateef. "An experienced attorney can tell you exactly what you need in your governing documents to avoid unintended consequences, and what should be reflected in your corporate minutes."

Bringing all the above up to date can add value to the business when the time comes to sell. Valuation can be dramatically affected by the failure to properly document and protect the company's core assets and is easily corrected by advance planning. This is especially important, says Lateef, when the value of the business is based on some multiple of EBITDA (earnings before interest, tax, depreciation and amortization), common with technology and other service companies.

"A family business may use certain tactics relating to family members' compensation or atypical expenses in order to minimize corporate tax, but in the long term, those will have an adverse effect on a company's EBITDA numbers. And while actions to improve EBITDA are good, a buyer may be skeptical if there's a sudden spike to the positive. The longer the runway you can put in place for your sale the better; frankly, many sophisticated buyers will expect two to three years of financials," says Lateef. "In addition, buyers will typically require some minimum working capital requirement and will factor in the potential cost of hiring a new CEO, CFO or CMO. These functions may have been handled more informally by the owner and family members and often at less than market value, but they represent real costs to the buyers."

Sometimes the answer to whether an owner really wants to sell is that he or she wants liquidity from the business and to move the company down to family members or long-term employees. In that case, if a third-party buyer can't be found, an employee stock ownership plan (ESOP) or other vehicle can be used to create liquidity for the seller and pass the company on to new owners. An ESOP can be a viable option for a privately held business, offering flexibility in structuring the transaction (the owner can stay on and exit in phases, if desired) and the benefit of "friendly buyers" who are motivated, through ownership, to continue the company's success. *(Please see our white paper "The Privately Held Business: Heading for the Exit" for more on an ESOP transaction.)*

Technology companies: special considerations

Although owners of every type of company in almost every industry sell their companies every day, technology companies seem to be the poster child for private business sales or initial public offerings (IPOs). Often, they're bought by "serial acquirers" in the technology industry. Recently, Lateef has handled a number of sales of technology companies to foreign buyers, particularly from India and China. (If you're a business owner and have interest from a Chinese company, please consult with an experienced attorney about possible restrictions under the Committee on Foreign Investment in the United States, or CFIUS.) But in addition to big names already established in the technology space, companies in a variety of industries are acquiring technology companies for their products and creative spirit.

If you own a technology company, there are some specific issues you need to be aware of. Typically, says Lateef, technology companies have a lot more shareholders than other types of companies. "Most family businesses don't have equity incentive plans as a primary, compensatory method to incentivize employees. Technology businesses really run on options—it can be the big payday for people who may not be getting paid much upfront, in part because many of these companies expect to either be acquired or go public. Going public is not something many family businesses do. So the number of shareholders can be very different with a technology company. And the treatment of various compensation plans in a tech company is something that needs thorough consideration early in the buy/sell stage."

Consider the scenario of a buyer wanting to do a stock purchase of your technology company. The decision to structure as a stock sale can be complex but is often centered on either avoiding adverse tax consequences to the sellers that may be present in an asset sale, or perhaps because the material contracts contain assignment provisions that can be avoided by purchasing all the stock. Now consider that a 1% shareholder could hold up the entire deal. The buyer is obviously expecting to buy 100% of the shares, but it's not uncommon for an employee or shareholder to want to "wait it out" and either try to extract additional compensation or an additional carve-out, such as dissolving a noncompete agreement.

In this scenario, there are vehicles to use early on to work around this situation. A tactic called a "reverse triangular merger" (a complex transaction that actually forms a new company for acquisition purposes), for example, requires only majority shareholder and board consent. Any dissenting shareholder hold-outs cannot stop the transaction but are instead forced to seek "appraisal rights."

"With that tactic, the only thing to be argued about is value," says Lateef. "And because the rules for appraisal rights are very complex, most minority shareholders either miss that window or elect to forgo that process and simply get a forced payout. The good news for a nontechnology family business planning to sell is that the shareholder count is typically quite low and lacks complicated voting structures."

Business broker vs. investment banker

Do you need a business broker or investment banker to help with your sale? While there's no hard-and-fast rule that you need either, it's important to understand the difference between the two. Business brokers can be "matchmakers," but they typically don't have the breadth and depth of skills found with investment bankers.

"If your deal is going to be in the neighborhood of $30 to $50 million, you should certainly consider an investment banker—and at that size, they'll consider you," says Lateef. "An investment banker will pore over the financials, dissect everything and do the proper financial due diligence. More than that, he or she is often an important problem-solver between the parties. There also may be an accounting firm involved. Certainly, experienced legal counsel is required. When you package all of those resources together—people who are highly experienced in these transactions—a large deal often moves along more quickly than a small one because the professionals know what to expect and get to the meat of the deal right away. Some family businesses hire a broker, who is paid a fee if the transaction goes through, but the transaction may not always be in the seller's best interest. A better approach we've recommended to family businesses is to hire a broker for a consulting agreement on *specific services* to help position the business for sale, for example to eliminate costs and increase EBITDA. It's like hiring someone to stage your house for sale." *(Please see "Putting the Business Transition Team in Place" under the Resources section for more on building your team.)*

Checklist for getting ready:

Consider these steps for getting the business ready:

- Clean up the business's financial statements.
- Secure agreements with key employees, suppliers and vendors.
- Lock down long-term leases.
- Tighten corporate governance.
- Review compensation and expense arrangements of family members.

Getting yourself ready:

- Evaluate your cash flow needs post-sale.
- Discuss with your advisors the benefits of lifetime transfer strategies to reduce overall family transfer tax.
- Determine the roles of family members after the sale.
- Consider the best ways to fulfill philanthropic desires.
- Think about your life as an investor, rather than a business owner.

Positioning for wealth planning strategies

As important as it is to position the business for sale to maximize its value, it is also extremely advantageous to position the family's personal financial arrangements to maximize the benefits of wealth planning strategies. If family members are employees of the business, and part of your long-term estate planning is to make sure some of the sale proceeds go to family, there are several ways to provide them with some equity and, as shareholders, enable them to be part of the sale and minimize the tax impact on them at the same time.

"Certain tactics can make a difference between the equity being treated as ordinary income or as capital gains," says Lateef. "And early planning can have a critical wealth transfer advantage as well. If there's plenty of time to plan for the owner's goals and the heirs' situation, we can often minimize the tax consequences by effecting the transfer before significant appreciation in value has occurred. Typically, early on, the valuation will be lower than at the last minute. The further in advance you can put lower-value holdings in specialized trusts, the greater the overall transfer tax savings to the family."

Depending on the structure of the sale, liquidity could be one immediate lump sum or well down the road, McKay points out. "For a sale with plenty of advance planning time, you and your advisor should have an in-depth discussion about your lifestyle needs and how your cash flow may or may not meet those."

If you own an equity stake in a privately held business being sold or going public and you have a fair amount of advance planning time, the choices you make could be some of the most important financial decisions of your career. "Actions before the assets have risen significantly in value will give you the most benefit," says McKay. "If you don't have a comprehensive wealth management plan, now is certainly the time to create one. Timing is extremely important to ensure the greatest leverage from placing undervalued pre-liquidity holdings into trusts. If you have a year before you believe the sale or IPO will take place, you could take steps such as exercising your shares to start the holding period and then transferring shares into a grantor retained annuity trust (GRAT), dynasty trust or a charitable remainder unitrust (CRUT). All of these tactics require a holistic look at your current and expected wealth and thoughtful discussions with your advisor. Ideally, you don't want to be in the situation where the prospect of realizing $1 million in one day seems more of a worry than a reward."

You should also discuss how changes in the tax reform act passed in late 2017 may affect your wealth plan when you sell your business. A key change is the doubling of the federal estate, gift, and generation-skipping transfer tax exemption amounts for an individual, from $5 million, adjusted for inflation, to $10 million, adjusted for inflation ($13.61 million for an individual in 2024).* Note that these new provisions are set to expire at the end of 2025, unless Congress changes or repeals the tax act before then. "In that sense, changes to clients' wealth plans are like a moving target," says McKay. "We're factoring in the estate tax change and higher income taxes in some states on a case-by-case basis for clients and running new scenarios, especially if they're ramping up to sell a business." *(For more on estate planning after 2017 tax reform, please see our white paper package "Lifetime Gift Planning.")*

About 30% of the business sale transactions Lateef handles are because the owner received an unsolicited offer. And it's common for the sales path with an unsolicited offer—from firm letter of intent to closing—to be as short as six to 12 weeks. "In those cases, there is very little that can be done to improve the financials," he says. "To get maximum value and realize your own personal planning goals, surprise is never your friend."

Minimizing personal income tax in a transaction is frequently a personal goal of the owner and the family. For obvious reasons, from a seller's perspective, it is advantageous to structure the transaction to result in capital gains treatment, according to Lateef. It is important to consider the impact that the form of the transaction will have on the tax treatment. An asset purchase will have different consequences in a C-corporation compared to an S-corporation or LLC, including potentially unanticipated issues related to built-in gains under IRS Section 1374. Further, the timing and manner in which the purchase price is characterized can have a significant impact on the taxable income. As an example, many times a buyer will structure part of the consideration in the form of an earn-out that is conditioned in whole or in part on continued employment by the seller. *(Please see sidebar on sale structure.)*

"While a seller will want the cash at sale, and any contingent consideration to collectively be deemed the purchase price—which can be treated as capital gains—a buyer may want to offset the risk by conditioning payment on the seller still being employed by the company at the time of payment," says Lateef. "That may be considered as ordinary income under Section 61 of the tax code and may be subject to the Section 280G deduction limitation on golden parachute payments, and would need to comply with Section 409A as well. Sellers are well advised to consult with experienced transaction counsel at an early stage of negotiations to avoid structuring issues."

In the short-term sale scenario, many sellers have undertaken only a minimum of family wealth transition goals—setting up a trust being the most common. Prior to closing, shares can be transferred from individual names into the trust's name. "It won't necessarily reduce their tax burden, but the planning window is so short preclosing that it's often the best an owner can do."

Importantly, says Lateef, most sales now are cash-only, as opposed to deferred stock transactions or mergers. "Cash is king now—liquidity is what most sellers want. If an owner is more interested in diversification of wealth and putting in place wealth transition plans, which is common with those who've spent decades building a business, they're far less interested in a sale that gives them stock in another private company hoping to go public and eventually receiving a big payout."

Post-liquidity planning for an executive whose company has had an IPO is also important. Newly public stock may be volatile in price, thinly traded and subject to lock-ups and restrictions. In addition, an executive may want to use a 10b5-1 trading plan for structured sales of stock, which need careful consideration with an advisor to make sure sales fit within the context of personal goals and risk tolerance.

**For estates of decedents dying and gifts made after 12.31.2017 and before 01.01.2026, the Tax Cuts and Jobs Act doubled the base estate and gift tax exemption amounts from $5 million to $10 million (IRC 2010(c)(3)). The $10 million amount is indexed for inflation occurring after 2011. Rev. Proc. 2023-34 (11.9.2023).*

A major shift in mindset about wealth

For many business owners, the transition to managing wealth, as opposed to managing a business, involves a major shift in mindset. Often, people who sell their businesses enter an environment for which they are unprepared. Post-sale, they're expected to understand complex investment concepts and discern effectively among investment alternatives, understand byzantine fee structures and effectively calibrate risks that they don't truly understand. On top of that, families must also navigate estate planning, new tax rules and risk management strategies in very different ways than they have before.

Types of sales—and their implications:

The sale of a closely held business can be structured in numerous ways: a lump-sum sale, an installment sale, an earnout sale based on a percentage of future profits or a sale to a charitable trust. A business owner may sell the business by transferring either the entire ownership interest (stock, partnership interest, membership interest) or just the assets of the business. The desired end result will help determine a sale's structure.

In a cash sale, in which the owner receives a lump sum of cash or property in exchange for all or a portion of his or her interest in the business, capital gain is generally recognized in the year of sale to the extent that the sales price exceeds the owner's basis, although there are exceptions.

The sale can also be an earnout. The purchase price of a business with an earnout agreement includes a contingent payment based on the company's future performance or some other matrix. The contingent purchase price is generally "earned" if certain future benchmarks are reached during a specified period after closing, and often includes a sliding scale on which the contingent payment will be made. Earnouts are typically useful when there is a gap between a seller's expectation of future profits and a conservative purchaser's estimate of the value of the business without the business owner's ongoing involvement. Earnouts may also be used to motivate and retain key employees of the business.

An installment sale can also be used, although this type of sale is more frequently considered if the business is being sold within the family. The big advantage is that it can provide regular cash flow to the departing founder. But it is best used for the sale of a stable business so that the cash flow is available for the new owners to make the installment payments.

An asset sale and a stock sale have big differences. **In an asset sale,** the purchaser acquires part or all of the assets of the selling company and gets a step up in basis on the assets purchased. The selling company also keeps liabilities not assumed by the purchaser. As to the tax effect, the selling company recognizes gain or loss on the sale of assets. Tax results differ depending on whether the entity being sold is a C-corporation, S-corporation or an LLC. Taxes may be part ordinary income and part capital gain, depending upon the assets sold. Additionally, the owners of the selling company may incur a second level of tax when cash or consideration is eventually distributed from the selling entity.

In a stock sale, the buyer has purchased stock—not assets. Therefore, the buyer gets a carryover basis in the purchased capital assets. Although there is no gain or loss to the selling entity, the selling shareholders recognize capital gains on the difference between their stock basis and their pro-rata share of the purchase price. Given the complexity of the different alternatives, it is imperative your team of advisors understands the structure and tax implications of your particular deal.

A large liquidity event is a major life development for both business owners and executives in a firm being sold. "Successful business owners and senior executives who've helped build and position a business for sale are extremely astute people who understand the financial component of running a business, but that's not the same as knowing whether to own one stock or another, or which hedge fund may be right, or on which area of emerging markets to focus," says McKay. "For the business owner used to control, so many things are now out of their own control."

In addition, the family who has been part of a privately held business for many years, individually and collectively, may have been extremely business-centric. Even if they have been charitably inclined and have established a family foundation, it's often been linked to the business. For many business owners, the transition from building a business to managing wealth involves a very different way of thinking.

"The challenges of a new situation, for both the business owner and for the family, are all things that you can work through with your advisor," says McKay. "Perhaps the most important message for owners of businesses whose goals are both the sale of the business and the achievement of their own personal goals is this: Even if you aren't planning at the moment to sell your business, you could operate under the presumption that someday it may be necessary or appropriate to sell. A similar attitude can be applied to overall wealth planning. Good planning for your wealth and your family has its own intrinsic rewards. Start early." ■

1 Evertt, Craig R., "2021 Private Capital Markets Report" (2021). Pepperdine Graziadio Business School.

Pre-liquidity tactics:

- Transfers to trusts, family LLCs and other entities
- Gifts through grantor-retained annuity trusts (GRATs), intentionally defective grantor (IDG) trusts and similar entities
- Charitable transfers and gifts
- Tax elections such as Section 83(b), which allow a business's founder or an employee the option to pay taxes on the total fair market value of restricted stock at the time of granting
- Tried-and-true tax strategies, such as accelerating expenses and deferring income