**A Talent*ed* Servant**



What is “Exit Planning”?

An exit plan is a strategic guide that outlines the steps for transitioning your privately owned business when you're ready to sell, retire, or transfer ownership to someone else.

This plan covers key aspects, including business, personal, financial, legal, and tax considerations involved in the exit process. Even if retirement is not on the horizon, having an exit plan is essential to account for unexpected life events, such as divorce, death, illness, or burnout.

Questions to be Addressed

When Do You Plan to Sell or Exit? The timing of your exit is one of the most flexible aspects of the process, as external factors can frequently shift your plans. Changes in market values, economic conditions, or personal goals may all influence your timeline. While entering a business may seem straightforward, exiting requires careful planning and the guidance of trusted advisors.

Who Do You Want to Sell or Transition Your Business To? One option is transitioning the business to family members involved in its operations. This could include gifting or selling shares to them. It’s important for family members to have hands-on experience in the business before the transition so they understand the operations and are committed to managing it full-time. Another possibility is transferring ownership to internal leaders, such as your management team. Often, existing management groups are well-positioned to take over the business. Other alternatives include an Employee Stock Ownership Plan (ESOP), selling to strategic buyers, or even competitors. When deciding on a buyer, aligning their objectives with yours is essential for a successful transition.

How Much Do You Want to Sell Your Business For? The third key aspect of exit planning is determining the sale price for your business, which depends on understanding its true value. The process of valuing your business goes beyond simply looking at your profits or assets and setting a price. It involves a comprehensive valuation, which we will explore in more detail later in this guide.

Why You Need a Plan

Delaying your exit strategy until the moment you're ready to step away can significantly limit your options, including who you can sell to, the price you'll receive, and the overall success of the transition.

It's also important to recognize that your exit plan will likely need adjustments due to factors beyond your control, such as health issues, life changes, departures of key employees, market shifts, or changes in the interest of potential successors. Better planning leads to better results.

Do You Have the Right Team Members?

Often, the professionals you have utilized in building your business aren’t the ones that can help you maximize its sales value. For example, attorneys with sell-side transaction experience are critical to the process, protecting you from liability while still ensuring the sale goes through. **Our professionals have an 85% success rate – 3x the marketplace average and for 96% of the list price.**

Determining Your Plan to Sell

A common mistake business owners make is overvaluing their business while underestimating the amount they will need to live on after exiting. A general guideline for retirement income is to aim for 75% of your current income to be available once you retire.

Business owners also need to take a close look at what personal expenses are run through the company, and account for them in their post-sale budget.

Are You Ready to Sell?

An asset gap refers to the difference between the resources a business owner currently has and the resources they'll need for a comfortable exit from the business.

To determine if an asset gap exists, you need to assess the value of your company and compare it to your retirement needs. To close the gap, you have three options: Stay and Work – If your business provides a good salary, supports your lifestyle, and you can't close the asset gap, it may be best to continue working until it makes financial sense to exit. Get What You Can – If you must sell your business for whatever value you can get, you’ll need to adjust your goals and lifestyle to reduce the asset gap. Build Value – Increase your business’s value before exiting to ensure your retirement goals are met. This strategy takes time, so it’s essential to start early. Do you have enough time to delay your exit and build more value in the business? Are you transferring ownership to family members, leaving significant funds in the business? Do you truly know the value of your business, or are you simply estimating its worth? Are you planning to work elsewhere, or will the business income be needed to support your family moving forward?

Options for Transferring Business Ownership

**Pass Ownership to a Family Member.**

After building a legacy, you may be ready to pass it on to a family member. This is a common dream for entrepreneurs, hoping to provide for generations. However, it may not be your children's dream, and they may have no interest in taking over. While you can offer them the business as a gift, it provides little or no value to you at the time, potentially limiting your retirement income if you haven't made other arrangements.

Statistically, transferring a business to family members has a low success rate. Surveys show that fewer than 30% of businesses make it to the second generation, and only 13% reach the third before being sold, merged, or closed. The dream of passing on your business to your family may not align with their goals.

Consider the following:

*Are you willing to finance much of the sale value?* Many family members may not have the financial resources to buy the business, meaning you'll need to leave money in the business.

*Why is a family transfer important to you?* If maintaining the mission, culture, and community relationships of the business is important, a family transfer can be appealing, as it continues the legacy you've built.

*Are your family members experienced and interested enough to take over?* Ensure they have the enthusiasm and ambition to lead the business. Future owners should work in the business for years to gain the necessary experience.

*Are there conflicts or family issues that may complicate the transfer?* Family dynamics can be challenging. Consider the strengths and weaknesses of each family member. Will you need an outside CEO to lead the company? Are there significant differences in how involved each family member is in the business?

*Is transferring the business the best way to provide for your family and future needs?* Keeping the business in the family may make financial sense, but if you have to finance much of the transfer, consider how that affects your future plans.

When transferring to multiple children, "fair" doesn’t always mean "equal." If one child is heavily involved in the business while another is less engaged, think about how to structure the sale to benefit everyone.

**Sell to a Stakeholder**

Selling to key employees who already know the business is another option. However, many employees may lack the financial resources or business expertise to take over effectively. You may need to spend time training them and could have to finance the sale personally or through your business, as obtaining bank financing can be difficult. Consider if you're willing to take on that risk or if your company’s finances can support this type of transfer.

Transferring ownership to key employees can offer similar benefits to passing it to family. It keeps the business within the community, maintains the company culture, and ensures employees are taken care of.

However, obstacles include the employees’ ability to finance the purchase. If they can’t afford to buy, you’ll have to finance the transaction, leaving you with less retirement income.

There are different ways to fund an employee purchase:

* **Installment Sale**
The buyer pays over time, based on an agreed price and interest rate. This option depends on the business's future income. If the business performs well, it’s a viable choice, but if sales decline, it can be risky.
* **Leveraged Management Buyout (LBO)**
The management team secures financing for part of the transaction, often with backing from a private-equity investor. This reduces the risk for the seller.
* **Modified Buyout**
This involves a two-phase sale: first, a minority interest is sold for several years, followed by the sale of the remaining shares at market value. While it can take longer to complete, it allows employees to take over in the long term.

Having a strong management team with a comprehensive understanding of the business is crucial. An enthusiastic employee may be great at their job but lack the business skills necessary for ownership.

**Utilize an Employee Stock Ownership Plan (ESOP).**

An ESOP allows you to transfer ownership to employees while providing value for you, but it has challenges. The owners may be reluctant to offer a personal guarantee, and there may be questions about who will run the company. ESOPs work like a 401(k) or profit-sharing plan but specifically invest in the business’s stock.

The ESOP trust is established with a trustee independent of the company. The business sells its shares to the ESOP, often requiring a loan to be taken out by the business to finance the purchase. This loan is then paid back through the ESOP, allowing employees to gradually buy into the company.

Considerations when setting up an ESOP include: management continuity, existing debt evaluation, willingness of the owner to accept fair market value for shares, legal limits on annual contributions to the ESOP.

ESOPs are gaining popularity but require significant time and planning to implement before your exit.

**Sell to Third Party.**

Selling to an outside buyer can provide a good value, but opportunities may be limited, especially in industries not experiencing rapid growth. Buyers may have limited financial resources, making it harder to raise capital. The economy and the nature of your business will influence your options.

The advantage of selling to an outside party is that you typically receive the bulk of the sale price up front. It is the quickest and most straightforward way to exit.

Advantages include: A short sales process, typically completed within a year, the possibility of long-term capital gains tax treatment on the proceeds, the ability to fully exit the business once the sale is complete (unless required to stay on in an advisory role), and eliminating family fairness issues.

Disadvantages include: Losing control of the business after the sale, potential future payments being tied to the company’s performance, the possibility of being required to stay on for a period post-sale, significant tax consequences, especially for C corporations, and the new owner may change the business culture, making it different from what you envisioned.

Proper planning, including a valuation and tax strategy, is essential to ensure a smooth sale. Letting go emotionally can also be difficult, as the business may no longer align with your original vision.

**Merge with Another Company.**

Merging with a competitor or selling to a private equity firm can offer a good deal, but the opportunities are often limited unless your company has something uniquely valuable, such as customer relationships, technology, or key employees. Mergers are typically used to expand market share, diversify products, reduce risk, and increase profits.

A merger combines two companies into one, often requiring cutting redundancies in staff, services, or locations. Mergers can be complex, depending on the products and services your company offers and the market demand.

There are five main types of mergers: conglomerate mergers, horizontal mergers, vertical mergers, market extension mergers, and product extension mergers

Advantages include: Potential for a higher sale price if there’s strong buyer interest, and increased opportunities for employees post-merger

Disadvantages include: Risk of staff reductions and service cuts, and the new owner may change the company’s operations

**Sell Your Assets and Liquidate.**

This is the easiest way to exit but typically provides the lowest value. It involves selling off equipment, assets, and real estate, collecting receivables, and paying off liabilities. Since liquidation signals the end of the business, the value you receive is generally lower than if the business were sold as a going concern.

**Donate Your Company to Charity**.

Contribute 99 percent of your business ownership interests into an irrevocable charitable trust (all non-voting shares). This will afford you a large tax deduction immediately and eliminate future estate taxes. It also allows you to maintain ongoing management of the business and draw a market salary. Income earned by the company is taxable to the trust, but at much lower effective rates than would otherwise be incurred. This increases the benefit for the charity.

Whichever exit strategy you choose, the sale price must align with the needs of both the buyer and the seller. Get in touch to explore these options in greater detail. admin@ministrygifting.com or 615.212.8902 You can also schedule a Zoom call at [www.ministrygifting.com/contact-10](http://www.ministrygifting.com/contact-10)

Setting the Sale Price

A business valuation is needed to establish the fair market value of your business. There are also other reasons for conducting a business valuation, such as preparing for a potential sale, establishing value for owners or partnerships, and addressing tax considerations.

The importance of a business valuation lies in the detailed analysis of your business’s financials, historical performance, and future projections. A valuation provides insights into trends, strengths, and weaknesses, while also evaluating how the business compares to industry peers and competitors. It also looks at the selling prices of . other businesses in your industry. While historical data plays a role, forward-looking projections and data are typically the most significant.

EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) EBITDA can also be a key indicator of a business’s value. Although it’s a historical figure derived from past financial statements, it’s important to remember that many business owners simply calculate EBITDA from their financial statements without adjusting for factors that may normalize that number.

Simply taking your EBITDA and applying a multiple is not enough, as this number could be overstated or understated. It’s important to be cautious with the numbers you're calculating and carefully consider how you're assessing your business’s value. Examples of normalizing EBITDA include situations where you're paying above or below the market rate for rent or if your owner compensation is higher or lower than similar owners in your industry. It’s crucial to thoroughly review historical data and financial statements to determine what the "normal" figures should be.

If you're selling to a related party, you need to transfer the business at fair market value. Selling it at a significant discount could draw the attention of the IRS, as they may view it as a gift rather than a legitimate transaction. To avoid this, you’ll need a business valuation to confirm that the sale is occurring at fair market value. If there is a gifting element to the transaction, the valuation will be necessary to support that gift.

**What Increases Business Value?**

*Financial Performance:* This value driver emphasizes the need for accurate financial information rather than requiring audited or reviewed financial statements. It's crucial that, during the due diligence phase, a potential buyer trusts the financial data provided. Reliable numbers and a record of positive outcomes, such as strong top-line revenue and solid bottom-line income, are key factors that buyers will evaluate.

*Growth Potential:* Growth potential is fundamentally tied to capacity. A business operating at full capacity will be less valuable compared to one with room to expand. Buyers are often interested in acquiring companies to elevate them to the next level. Major aspects of growth potential include increasing revenue and ensuring earnings predictability.

*Structure:* Independence is the central theme of this value driver. A business should avoid dependence on a single customer, vendor, supplier, or even employees. Like Switzerland's neutrality, a company should maintain impartiality with its stakeholders to prevent reliance on a single source. Over-dependence on any one customer, supplier, or employee could negatively affect the company's value.

*Working Capital.* This represents your company’s cash flow — it’s the difference between receivables and inventory versus accounts payable. While it may seem wise to pay all vendor invoices at once to eliminate payables, that may not always be the best choice from a cash flow perspective. You don’t want to have more receivables than payables on your financial statements, as that means you're spending more than you're bringing in. Maintaining a balance between receivables, inventory, and payables is crucial. When preparing to sell, these numbers will impact the business's value and ultimately the sale price, so it's important to manage this balance carefully.

*Recurring Revenue*. Many businesses focus on chasing one-off sales, but developing a stream of recurring revenue can significantly increase your company’s value. To create a reliable, recurring revenue stream, think about what products or services you can offer that will automatically repeat over time. For instance, service contracts are a great example. A customer might purchase a product and then opt for a yearly service contract, which could be billed monthly and renewed annually. Building a system where revenue recurs automatically reduces the need to constantly chase new sales, offering you more predictability and allowing for better budgeting. Recurring revenue can greatly increase your business's value and the multiple applied during a valuation.

*Control.* This value driver focuses on differentiating your business from competitors. What can you do to stand out? The key is to understand and meet your customers' needs. Every business should push itself to answer this question. By offering something unique that no one else provides, you can create pricing power and establish a competitive advantage that sets you apart.

*Leadership.* Do you have a management team in place, or is the business entirely dependent on you? This aspect focuses on shifting the owner’s mindset from being deeply involved in every detail of the company to focusing more on high-level strategic areas and preparing for the future. If you're looking to sell your business and it's primarily dependent on you to drive operations, it will be challenging for someone else to take over. As the owner, it's crucial to plan and work on building your company's value. Your management team should be capable of handling day-to-day operations, enabling a smoother transition when a new buyer comes on board.

The Due Diligence Phase

If you have sufficient time to prepare for the due diligence phase, you'll maximize the value of your business. Pre-planning due diligence is essential because it allows you to recognize and highlight your strengths while also identifying and addressing any weaknesses before they become an issue.

During due diligence, the buyer will review both financial and non-financial information. They will examine every contract, including some you might not even be aware of, and ensure there are no hidden liabilities. They will also verify that everything is in order.

Before due diligence begins, while you're still negotiating with the buyer, you have more control over what information you provide and how it's presented. However, once due diligence is underway, you'll need to supply whatever they request, within reason. At this point, you’ll have less control over how your information is viewed or what you must disclose.

By understanding your own financials and having the chance to address any issues in advance, you’ll ensure a smoother due diligence process and be better positioned to get the best value for your business. Even if you plan to sell your business to a family member, due diligence and a proper business valuation are still crucial. You don’t want to pass on any liabilities to your family members, and depending on their involvement in the business, they may not fully understand the owner's responsibilities. They will still need to go through the due diligence process.

The Agreement

A buy-sell agreement is a legally binding contract that outlines how a partner’s ownership interest in a business will be transferred if the partner passes away or leaves the business for any reason. Typically, the agreement specifies that the remaining partners or the partnership itself will purchase the departing partner's shares.

These agreements protect your business by outlining how various situations will be handled. Like all contracts, they define triggering events, payouts, and valuations. While these agreements are typically designed with the expectation that they won’t be needed, now is the ideal time to review your buy-sell agreements and evaluate them against potential issues.

**Overlooks Business Continuity Risks**. Many buy-sell agreements fail to address the challenges that arise for the business, remaining owners, and the deceased owner’s family after an owner exits. These agreements typically only focus on the transfer of ownership in the event of death or permanent incapacitation.

For instance, if the surviving owner lacks the resources to cover personal guarantees made by the deceased owner, the business could face financial difficulties when those guarantees are called in. Similarly, if the deceased owner played a key role in the company, such as being the primary rainmaker or COO, and no one is available to step into those positions, the business may struggle to continue. At best, a buy-sell agreement focused solely on ownership transfer upon death (or sometimes permanent incapacitation) ensures that (a) the surviving owners take full control of the company, and (b) the deceased owner’s estate is paid a fair cash value for the ownership transfer. However, it doesn’t address other critical issues that could arise.

**Neglects Common Lifetime Exits**. Does your agreement account for an owner's exit during their lifetime? Events like incapacitation, divorce, bankruptcy, retirement, termination of employment, or disputes among owners are more likely to occur than an owner’s death and can trigger the need for ownership transfer. Unfortunately, most buy-sell agreements fail to consider these scenarios.

**Overlooks the Needs of the Deceased Owner's Family**. Most buy-sell agreements focus primarily on benefiting the surviving owners, often neglecting the needs of the deceased owner’s family. Even if the family receives buy-sell proceeds reflecting the full value of the deceased owner's business interest, the amount is typically insufficient to maintain the family’s lifestyle at the same level as the owner's income did. In many cases, the primary goal for business owners—ensuring financial security after exiting the business—cannot be met through the proceeds of a buy-sell agreement alone.

The financial gap for the deceased owner’s family arises from the loss of both the ownership stake and the income stream generated by the business, along with the termination of the deceased owner’s salary. Buy-sell agreements generally don't address these issues and can even exacerbate them since the decedent’s income rights cease after the ownership transfer. Advisors must help business owners answer the critical question: "If you pass away, what will replace your income for your family?" There are several potential solutions to this, which may involve restructuring the buy-sell agreement.

**Too Simplistic for Complex Situations**. Many buy-sell agreements are overly simplistic and fail to address the personal complexities of the owners and their relationships. For instance, in businesses with multiple owners, there may be a desire to treat certain owners differently, or one owner may be uninsurable. In family-owned businesses, personal factors and dynamics often influence the design of the buy-sell agreement, which many standard agreements fail to consider.

**One-Size-Fits-All Valuation Formula.** Using a basic valuation method, such as agreed-upon value or book value, can be overly simplistic. While these formulas might work when a business is first established, they fail to adapt adequately as the business grows and evolves.

**Outdated**. Although buy-sell agreements don't have expiration dates, they should be periodically reviewed. When left forgotten in drawers and not updated to reflect current business conditions or the changing goals of owners, they can lead to unpleasant surprises. Owners depend on buy-sell agreements to manage emotionally charged situations, and if those agreements don’t account for business changes, they can create significant issues for everyone involved.

**Improperly Executed**. If there is a lack of sufficient insurance funding or if beneficiary and ownership information is incorrect, the buy-sell agreement cannot fulfill its intended purpose.

Tax Efficient Structure

Tax expenses are just one factor in determining the net proceeds from the sale of a business. Other factors include debt, working capital, and transaction costs. The way you structure the transaction can significantly affect how much you ultimately take home from selling your most valuable asset.

**Deal Structure (Asset or Stock Sale):** Sellers usually prefer a stock sale because it allows for capital gains treatment and avoids double taxation (since some taxes in an asset sale are subject to ordinary rates due to recapture rules). Buyers typically favor an asset sale, as it enables them to maximize future depreciation deductions by writing up the tax basis of assets. Sellers should consider negotiating a gross-up payment from the buyer to cover the additional tax burden.

**Business Structure and Tax Implications (C-Corp or S-Corp - Pass-Through):** *C-Corp (Asset Sale):* The gain is subject to corporate-level taxes, followed by shareholder-level taxes (on dividends or capital gains). *C-Corp (Stock Sale):* May qualify for 1202 gain exclusion and/or long-term capital gain exclusion, depending on the requirements. *S-Corp (Asset Sale):* The gain passes through to the seller, subject to only one layer of tax. *S-Corp (Stock Sale):* A 338(h)(10) election can be made to treat the sale as a deemed asset sale.

**Purchase Price Allocation Structure:** In an asset sale or deemed asset sale, how the purchase price is allocated can have significant tax implications for both parties. Both the buyer and the seller submit matching purchase price allocations across various asset classes. This impacts how the seller calculates gain or loss and establishes the buyer's depreciable basis in assets (any price increase for the buyer results in depreciation recapture for the seller).

**Installment Sale:** An installment sale may be used when the buyer lacks sufficient cash or agrees to pay a contingent amount based on the business's future performance. This approach can also be advantageous for the seller if they want to spread the gain over several years, potentially keeping them below the thresholds for triggering the 3.8% Net Investment Income Tax (NIIT) or the 20% long-term capital gains rate.

However, it's important to be mindful of potential drawbacks of an installment sale, such as an increase in tax rates, portions of proceeds becoming ineligible, or the risk of default. In these situations, it's essential to work with an accountant experienced in business sales or transfers. They can assess your unique circumstances and develop a strategy to minimize your tax liability.

Finally

Exit planning creates a roadmap for how you will leave your business, assessing both the assets you currently have and their after-tax monetized value. It also outlines how those assets will support you after your transition. Income stream planning should extend beyond just the moment of your business exit.

A key component of planning is determining the income your family will have if the unexpected occurs and you are unable to survive until your planned exit. By aligning both your estate and exit plans, you can maximize the time and resources spent on exit planning while ensuring your estate plan complements it. Since both plans share similar objectives and strategies, they should be developed in coordination with your advisory team.

A business valuation by a qualified expert will provide realistic expectations of potential proceeds from selling or transitioning the business. It will also highlight whether you need to implement strategies to grow or protect the business’s value.

If you already have an estate plan, revisiting it and aligning it with your exit plan will provide a comprehensive strategy for your future income. Exit and estate planning should also address what will happen to your business and estate in the event of your incapacity or death, especially if you remain active in the company. Proactive planning ensures the business continues running smoothly and your family’s financial needs are met in case of the unexpected.

**How Does an Estate Plan Assist in Exit Planning?** Establishes a financial security plan for your family’s income stream. Specifies who will inherit the business within your family. If your family is not the successor, your estate plan should detail how the business will be managed. Protects your assets from creditors and minimizes tax implications. Ensures your charitable goals are fulfilled.

An estate plan should not be viewed as a substitute for an exit plan. However, the implementation of your estate plan should occur well before any exit, just as exit planning should begin years ahead of your intended departure.

Often, asset protection planning and strategies for minimizing estate and income taxes involve the use of trusts or other entities. If these are not properly set up well in advance of your exit, they could limit your ability to achieve your goals and objectives.

Get in touch to explore these options in greater detail. admin@ministrygifting.com or 615.212.8902 You can also schedule a Zoom call at [www.ministrygifting.com/contact-10](http://www.ministrygifting.com/contact-10) **Our professionals have an 85% success rate – 3x the marketplace average and for 96% of the list price. Our professionals have an 85% success rate – 3x the marketplace average and for 96% of the list price.**