By R. Jeremy Wilson

Preparing the Family Business for Sale

A strong advisory team can help the owner avoid conflicts and maximize the value received

For most business owners, the sale of a business is a once-in-a-lifetime event. Without experience in this transaction, the owner likely begins the process with uncertainty and trepidation. While a great deal is at risk for any business owner, the owner of a family business has added pressures. Whether there are additional family members with ownership interests or relatives who are key employees, family ties require an extra amount of care when selling the business. To ensure the family addresses all concerns and receives the maximum value for the business, the family should take certain steps to prepare the business for sale. In the same way a homeowner prepares his home to be sold by making repairs, removing clutter and staging the home to look its best, the head of the family business should do the same—and it all begins years in advance.

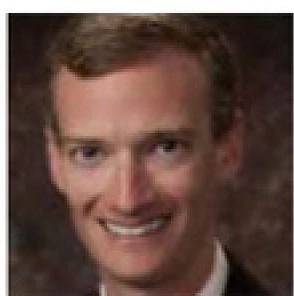
Attorneys, accountants and financial advisors must bring their practical experience and technical expertise to prepare clients for the unknown, both financial and otherwise. A strong advisory team can help the owner: (1) enhance the value of the business by creating a unified family front and a business with clean books and updated contracts and agreements; (2) plan ways to defer or mitigate taxes by considering the tax implications of the sale; and (3) pave a path to higher valuations and stronger family relationships.

Prepare the Family

Jesus said, "If a house is divided against itself, that house cannot stand."[1] This adage also applies to the family business. If the family lacks harmony and consensus, the value of the business is diminished. Of all the recommendations made to an owner considering the sale of the family business, the most important is to discuss the possible sale with the other family members. Failure to discuss these intentions can lead to feelings of resentment even years after the transaction has closed. An advisor well-versed in the specific challenges faced by family businesses recognizes the importance of open communication.

While these discussions are family-centric, the involvement of the trusted family advisor frequently helps diffuse the emotionally charged room. Too often, the advisory team members focus on their respective disciplines without considering the nonfinancial, family issues. The advisor closest to the family must proactively encourage these discussions upfront. Delaying or omitting these conversations will only exacerbate the potential conflict, which may center on a family member's future employment after the sale or the resurfacing of unresolved past issues. In either case, the advisor must work as part facilitator and part mediator to bring understanding and closure to the issues. The advisor should also discuss the process that can be expected and the steps that will be taken to ensure all family members are adequately informed.

While the owners might sell their interest for a life-changing amount, other family members may require continued employment. In this case, the owners should commit to assisting these individuals, whether negotiating their retention by the purchaser or finding them new opportunities with vendors, customers or others in the community. This may also be an opportunity for the advisor to provide coaching and guidance to these family members to assist them in securing future employment. Regardless of the manner in which it occurs, the family members should feel comfortable that the owner understands and will address their needs.



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Strong emotional ties may exist, particularly for second and third generation family businesses. Perhaps the business represents mom to certain family members. For another family member, the business might have been the tool for correcting the course of a prodigal child. Whatever the specific connection, in nearly every case, there are personal attachments that make the family business more than just an investment or employer. The advisor must understand the specific emotional connections and offer alternatives honoring these influences. For example, if the business is representative of a deceased parent or grandparent, consider creating a memorial scholarship or service award in honor of mom or granddad. Or, find tangible effects within the office.

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Perhaps there are framed articles, dad's desk, mom's chair or first edition signs that would allow the other family members to memorialize the emotional ties after the business is sold.

There's occasionally a family member who feels he's qualified to take over the business, particularly when a sale is being considered. This individual will suggest that, rather than selling out to a competitor or other third party, he should be given the torch to carry on the family tradition. Unfortunately, this individual may not be equipped for such responsibility, and the owners might feel that value will be lost if the self-appointed heir is handed the reins of the company. The family advisor must be prepared to guide this individual in a different direction, understanding his talents and suggesting an alternate, constructive path to carry on the family legacy.

Strengthen the Financial Statements

Once the family members agree to pursue the sale (or at least agree not to interfere), the advisor shifts the focus to preparing the business to fetch the highest price. He begins by reviewing the financial statements. The numbers never lie—but they can be skewed. Depending on the industry and nature of the business, the client's contracts and employment agreements can be extremely valuable. However, the financial data is almost always one of the most important elements reviewed by a potential buyer. For this reason, creating a clean set of financial records should be a priority.

While all closely held businesses pay some personal expenses, the family business typically multiplies this by the number of family members involved in the business. Common examples include: vehicles, life insurance premiums, club memberships and higher than comparable compensation. These expenses are unnecessary for a third-party buyer, and as such, the expenses distort the financial results when they're included. While the buyer or his advisors will normalize the expenses, it can cause uncertainty in the future returns of the business. If the family business reports these amounts as distributions or dividends, the potential buyer can clearly see the financial results of the operations. This process is incredibly important for those buyers seeking third-party financing. While the aforementioned normalization allows the potential buyer to calculate anticipated financial results, many financial institutions aren't as comfortable with such adjustments.

Financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) and audited by an independent CPA are typically viewed much more favorably than those not meeting these requirements. Financial statements in accordance with GAAP can be compared with other GAAP financial statements, allowing the financial operations to be compared to industry competitors.

By having the financial statements audited by an independent CPA, the potential buyer understands that an expert has analyzed the statements. In contrast to cash-basis financial statements (or worse yet, income tax returns), a potential buyer will have greater confidence in the accuracy of the outstanding accounts receivable and any related reserves for bad debts. Similarly, for inventory-intensive businesses, audited financial statements indicate that the valuation, including reductions for obsolescence, is reasonably stated within an immaterial variance. A potential buyer of such a company is able to spend less time on whether obsolete inventory

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exists and more time on the quality and substance of the company. Like a defense attorney creating reasonable doubt by raising ancillary issues, many buyers seek inconsistencies within the company financial statements to negotiate the purchase price down.

Formalize Family Compensation

One expense item potential buyers frequently scrutinize is the compensation, particularly for owners and family members. The buyer wants to estimate what his costs will look like when he's the owner. For this reason (as well as to substantiate the income tax deduction), consider engaging an expert to conduct a compensation study. Based on the industry, geography and specific needs of the company, the expert can provide a range of the compensation necessary to attract a non-related replacement. The owner should then adjust his compensation to reflect these findings. This adjustment will directly affect the valuation of the company by increasing net income and cash flow (assuming this is a reduction of the current compensation amount), thereby raising the valuation. By having the compensation study in place, an appraiser won't require an adjustment for related party compensation.

Your client can bolster the appropriateness of compensation by having employment agreements in place. The agreements can also aid in securing post-sale employment for family members. As previously discussed, there might be family members in the business who need to retain their jobs. The negotiation of employment for these family members is easier when there's an employment agreement already in place. The purchaser can feel comfortable that the employee has outlined duties and is accustomed to being held accountable for performing them.

Minimize the Income Tax Expense

While there are a number of expenses incurred in the sale of a business, perhaps the greatest is the income tax. Depending on the structure of the transaction, the federal rate can be as high as 39.6 percent on the gain. There are some time-honored strategies, such as installment sales and stock sales that can help decrease the total taxes paid. Unfortunately, in an era in which fewer qualified buyers exist, sellers often lack the negotiation power to demand such terms, or they aren't comfortable with the credit of the potential buyer. Thus, advisors must be more creative in helping their clients save taxes. For example, if the owner anticipates the sale in advance, he should consider instituting an age-weighted deferred compensation plan. In this way, he's able to set aside money in his retirement account at an accelerated rate, while affording a deduction to the company. This is a tax-efficient way to get money out of the company. While it does reduce the value of the company, it's likely better than increasing the sales price, which increases the taxable gain and ultimately the taxes paid.

Advisors should carefully examine the participation of the owners in the business. When the Affordable Care Act introduced the net investment income tax (NIIT) under Internal Revenue Code Section 1411, the cost of selling investments became increasingly expensive. The NIIT imposes an additional surtax of 3.8 percent on investment income for taxpayers with adjusted gross income in excess of $250,000 ($200,000 for single filers). The exceptions to the NIIT include the gain on the sale of an S corporation or partnership interest in which the taxpayer materially participates.

> The advisory team should consider the benefits of a preliminary business valuation.

While many owners undoubtedly satisfy the criteria of material participation under IRC Section 469, consider the many gift and estate-planning strategies employed over the years. Think of the grantor retained annuity trusts that have termed out and have placed ownership interests in the hands of non-participating children or the non-grantor trusts that, whether through inter vivos planning or under the will of a parent, hold ownership interests. For such non-participating owners, the NIIT is applicable. In the case of the non-participating child, the advisor should consider whether the child could achieve material participation for years prior to the sale. In this way, he could potentially avoid an additional tax of 3.8 percent with a documented history of material participation. With respect to the trust, could it be terminated in favor of the active owner to avoid the NIIT?

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Alternatively, could the decision in *Frank Aragona Trust v. Commissioner*[2] support trustee participation, thereby allowing the trust to avoid the NIIT? These are questions best considered in advance to prepare the strongest case of support.

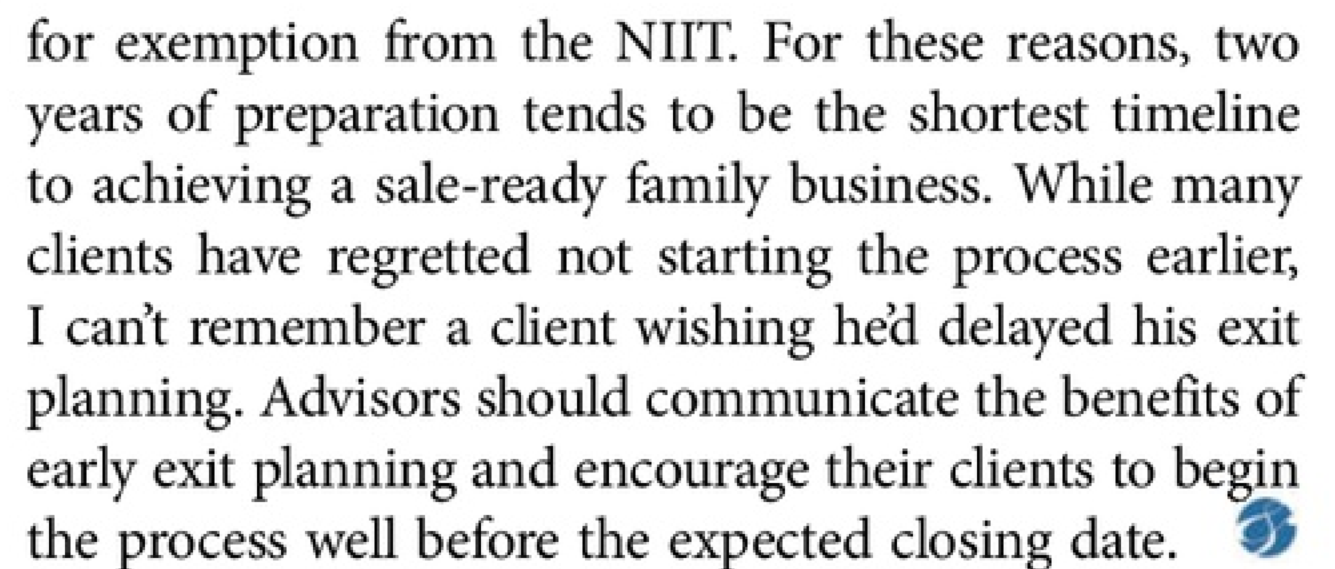
Assess the Business Value and Risks

The advisory team should consider the benefits of a preliminary business valuation. The appraisal doesn't need to fully comply with the Internal Revenue Service standards, as it's for internal discussions. Analogous to a desk review for real estate, its purpose is to frame the owner's expectations. This step is particularly valuable in the situation in which the owner's expectations are seemingly unrealistic. Many otherwise good deals have dissipated due to an owner holding on to unrealistic values, only to later accept a lower value when all other suitors have left the table. Conversely, the owner might accept the first offer because it's higher than what he was expecting, only to discover later it was less than market value. Either case will leave an owner disappointed. By valuing the company in advance of an offer, the owner can mentally prepare for what an acceptable offer might look like.

The attorney could conduct a limited mock due diligence investigation. He could perform lien searches, review vendor contracts, lease agreements and key employee agreements. He can do such reviews in a relatively cost-effective manner. By identifying the issues in advance, the business will be in a stronger negotiation position. This exercise will also prevent any surprises from arising in the course of an actual due diligence investigation, allowing the advisory team to assess the risks of the business from the view of a potential buyer.

Communicate the Timeline

The process of preparing the family business for sale should begin long before the negotiations with the potential buyer. Depending on the findings from the financial statement audit and the mock due diligence proceedings, preparations might easily take three years to complete. If significant family tensions exist, the process may require an even longer timeline. A 2-year timeline provides for comparative audited financial statements and a full cycle of contract renewals. This time period also allows owners that previously failed to meet the material participation standard to create a case



for exemption from the NIIT. For these reasons, two years of preparation tends to be the shortest timeline to achieving a sale-ready family business. While many clients have regretted not starting the process earlier, I can't remember a client wishing he'd delayed his exit planning. Advisors should communicate the benefits of early exit planning and encourage their clients to begin the process well before the expected closing date.

Endnotes

1. Mark 3:25, *New International Version.*
2. *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014).

SPOT LIGHT

Dress Rehearsal

"Danseuses," by Maurice Brianchon, sold for $50,995 at Sotheby's Impressionist & Modern Art Day Sale in London on Feb. 4, 2016. Brianchon painted in a style known as "poetic reality," producing many still lifes in a progressively vibrant palette. He was selected to represent France at the prestigious Venice Biennale in 1934.

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