



# Exit strategies for owners of a private company

Seize the opportunity to secure your future

You've worked hard to build a successful company and create a legacy. Selling your business is a high-stakes and emotional event. You need a no-surprises approach to help guide you through the final few steps to realizing the value you have worked so hard to achieve.





We're in one of the **longest-running positive M&A cycles** in recent history. Even as global economic headwinds develop, corporate and private equity investors continue to experience unparalleled access to **capital for potential deals**. This suggests that the current wave of US industry consolidations and aggressive private equity investing will continue into the foreseeable future, even as deal volume has slowed from recent peaks.

At the same time, with increasing valuations for companies, expectations on sellers are more rigorous, even punishing on surprises. Proactive preparation has become mandatory; processes are more accelerated and data-driven, quality of earnings analysis and sell-side due diligence have become table stakes. Sellers have to respond appropriately and with confidence as experienced buyers move toward a close.

Selling your company takes robust planning and discipline. Whether you are **divesting the business** completely or bringing in a private equity investor to fuel additional growth, the process you develop and follow will play a critical role in creating value for your shareholders and family.

Everyone has a lot more data than even five years ago to value your business, including benchmarks and operational data sources. The one piece of information the market doesn't have is your story: what you've done and what the business can do next, setting up a clear and credible case for terms you can justify.

The glue that holds it together is that you are clear about buyers' expectations, understand your company's value and can evaluate and explain the prospects for your business. Above all, you need to have worked through what you want to accomplish for yourself and your stakeholders with a prospective transaction. To a large extent, this will determine the right exit strategy for you.

Many entrepreneurs today are motivated by more outcomes than retirement or a simple wealth event. You may want to consider taking a "second bite at the apple." This typically involves structuring an exit that divests a controlling stake but creates a continued role to grow the return on the remaining stake.

Whatever path you may be considering, we hope this guide serves as a useful starting point for the conversations you will have with your stakeholders, trusted employees and family, as well as your advisers as you realize the value you've worked hard to create.

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## The five phases of a well-structured exit process



### 1. Making the decision to sell

Identifying business and personal goals and objectives, both monetary and non monetary. To a large extent, they determine the right exit strategy.



### 2. Understanding the buyer universe

Seeing the business through the eyes of potential buyers. Managing a continuing role in the business. Expectations about control. Determining the appropriate transaction structure. Reconciling buyer and seller objectives.



### 3. Preparing the business for a sale

Putting together the best package. Valuing and evaluating the business, including price expectations. Determining the right time to sell. Pre-sale checkup and corrective actions. Preparing sell-side due diligence. Preemptively addressing potential buyer concerns. Managing employee expectations and putting in place appropriate retention packages in the transaction setting. Turning complexity into confidence.



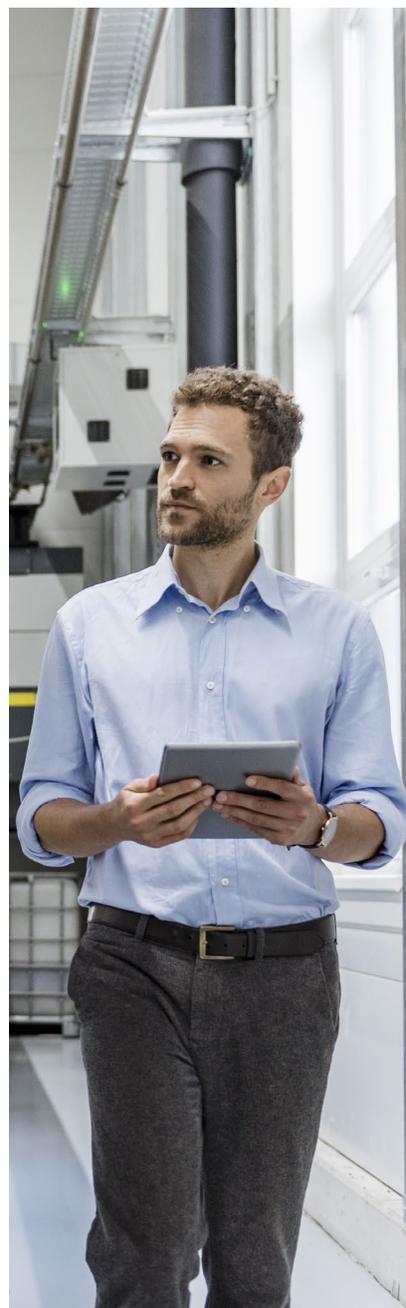
### 4. The deal process

From negotiations to closing. Managing due diligence with potential buyers. Using advisers effectively. Avoiding pitfalls. Structuring a tax-efficient sale.



### 5. Preparing for life after the deal

How to preserve and transfer the wealth generated by the exit from your business. Estate and tax planning considerations.



Download the full report:

[www.pwc.com/pcs/exitstrategies](http://www.pwc.com/pcs/exitstrategies)

## Ten principles for selling a business successfully

### 1. Mind the store

Selling a business consumes significant amounts of time and energy. It is surprisingly easy for you—or your entire management team—to become so focused on selling that you or they neglect the day-to-day demands of running the business. Run the business like you aren't selling—that's how you can best preserve optionality and negotiating leverage, especially as you are very likely to experience delays in the process.

### 3. Be prepared

Don't rush to market. Lack of adequate preparation before you begin the selling process always creates problems. Optimizing value and getting to closing requires a polished and complete presentation. Be prepared for questions and challenges. External advisers should help frame the likely buyer concerns and guide on mitigation solutions. Knowledge allows for better control of the process and helps to ensure an optimal outcome.

### 5. Value your business on its own merits

Once you hear "what the other guy got" for selling their business, you might not be content with a lower offer for your business, even though it may be optimal or appropriate given the circumstances. Comparable transactions can provide guidance, although data required to make a true apples-to-apples comparison is typically limited with private companies. In the end, every deal is unique. The valuation stories you hear rarely include all the salient information about the many differences between two businesses.

### 7. Be sure everyone's on the same page

The sale process is complex, requiring effort by multiple people across the business. Unless functional leaders have been briefed and prepared, buyers will receive mixed messages and the process will bog down.

### 9. Take care of your people

A high-caliber management team often represents the most important asset of the business. To optimize value, you must establish a structure early that rewards and retains talent by establishing appropriate incentives during a transaction. The skills, knowledge and experience possessed by your team are not easily replaced.

### 2. Bring in expertise

As a business owner, you know your business and you're used to making the decisions. In a sale, however, you're likely navigating uncharted waters. Proven and collaborative deal advisers will help you manage the sale process, tell your company's story, find the right buyers and negotiate to optimize value. Good advisers more than pay for themselves. Given the time-consuming nature of the process, this will also allow you to continue to manage the business without distractions.

### 4. Address data challenges and trends upfront

If a potential buyer should uncover negative information late in the game, it could result in a significant reduction in the price and jeopardize the transaction itself. Present yourself and your company well but remember that numbers and facts that stick are always better than ones that erode.

### 6. Keep the informed circle small

Although the circle should be small, news of an impending sale can make employees nervous and spook the trade. You don't want a competitor whispering to customers or clients, "You don't want to use them. They're about to be sold." Premature or incorrect messaging poses a retention risk for employees and management. Keep the process confidential and reduce uncertainty as quickly as you can but realize that word eventually gets out. As the process moves forward, the circle will expand as you will need management across all functions aligned.

### 8. Keep your options open

Competition among buyers is a good thing. Run a process that pushes buyers to pay more to win. It's possible to waste a great deal of time and money with a buyer who makes an exciting initial offer but later pulls away from that price or those terms. Meanwhile, you may have let other suitors fall away. It's also important to not have a predisposition towards a type of buyer, i.e. corporate vs PE; domestic or foreign.

### 10. Know that dollars are not the only factor

A promise of more money with more contingencies may not be the right exit strategy for you. Take time to understand the present value of structured components, such as working capital targets, seller paper or earnouts and the associated risks. Investigate whether the potential buyer has a good track record of sticking with original offers, has the necessary financing to close a transaction and pay attention to other issues that could stop you from signing with a particular buyer. A process that drags does not favor a seller. Certainty to close should be a key consideration.

# Making the decision to sell

You recently chatted with an investment banker about your thoughts for the future of your business. He tells you an IPO is definitely the way to go. Is it?

*It depends.*

Neither of your two grown children has indicated a desire to take over your business someday. Business is good, so you're thinking of selling soon. Should you?

*It depends.*

You've just been informally approached by a potential buyer and an intriguing ballpark price was raised. Is the price fair?

*It depends.*

You're aware financing conditions are favorable and that bankers will say that now is the optimal time to sell. Is it?

*It depends.*

While retirement is the most frequently stated reason for the sale of a business, an ownership transfer can take place at any time. The pattern of your business—and your life—is different from all others. Your unique history can lead to an optimal exit only when you have thoroughly defined your objectives and priorities.

Yet too often, private company owners are simply reactive, which generally yields a suboptimal result. They may delay planning an exit strategy because they are caught up in day-to-day operational demands or they may find it difficult to acknowledge that the time has come to start thinking about letting go of the business.

Being proactive empowers you to assert more control when the time is right while enhancing the eventual value of the business to buyers. The process of identifying objectives, to a large extent, will help you determine the right exit strategy.

Objectives will be both financial (liquidity, valuation, taxation/estate planning) and non-financial (succession, employee and other stakeholder concerns, and family dynamics).

Some of your priorities will be personal. Don't put off personal (or family) tax and wealth planning, it's as important to an overall success story as getting the business in shape and sold. Whatever type of exit unfolds, one outcome should be clear at the onset: you will find yourself in a different position financially overnight. There are portfolio management, retirement income and family trust options to consider, as well as significant tax impacts in a sale. Topics like these should be addressed before the business issues are addressed. We cover these issues in depth in the final section of this report, *Preparing for life after the deal*.



Finally, you may want to explore paths to capital, particularly an IPO. Going public is a huge decision for any company. Management will need to be prepared to meet shareholder and market expectations from day one. Learn more about going public from our guide, [Roadmap for an IPO](#). There are other private capital market alternatives to raise either primary capital (for the business) or secondary (to take capital out of the business). These alternatives include straight debt, equity (for a minority stake) or various structured alternatives.

**The reality is most private companies that are not passed on to the next generation will be sold.**

These questions should help you form a clear view of the future direction for you and your business. As you consider these, you should start to get a sense of an optimal time line for you to transfer ownership.

- Do I want to stay involved in managing the business? For how long?
- Do I want to retain a financial stake post-sale?
- Is family legacy preservation a priority?
- Does my business have all the necessary managerial expertise required to be successful in the future?
- Is the business on solid footing with a strong foundation and demonstrable growth story?
- Are there employees or others whom I want to protect or reward?
- Does the business have an appropriate capital structure and access to funding to take advantage of opportunities?
- Do I care who buys the company?

## The first step is to identify the value drivers of the business

The qualities that make a business different are the value drivers. Identifying the value drivers that make your business stand out is how to begin to build your story. As a result, you'll ask: What makes my business scarce, protected and "sticky"—and thus, valuable?

There are a lot of value drivers, some more tangible and quantifiable than others. Attractive industry fundamentals often provide for a more favorable selling environment. Free cash flow is an important value driver for most buyers, who will model outcomes for future cash flow to level set value for the business. Other value drivers are perceived. Think of competitive advantage, **customer relationships**, attractive growth opportunities or quality of management. Once you isolate your company's fundamental value drivers, you can monitor and take action where needed long before you want (or need) to sell. For example, the balance sheet and cash flow may need to be improved, perhaps through cost cutting or a debt restructuring, or the management team may need to be upgraded. New internal or external managers are sometimes more willing to address certain personnel issues, resulting in improved efficiency and morale.

### Typical value drivers may include:

#### Market Dynamics

- Cash flow and profitability
- Capital requirements
- Strength of management and workforce experience
- Attractive industry fundamentals
- Synergies (both revenue and cost) expected from a merger/acquisition
- Quality and reputation of the business
- Customer relationships, size and longevity
- Growth trends for key products and services
- Distribution network
- Intellectual property, such as patents, trademarks and brand name
- Technology and speed of obsolescence

It is often prudent to consult with an adviser in making valuation assessments. Because a private company owner's life is often so closely intertwined with the business, it is usually difficult for them to objectively assess the value of the business, which can directly impact the attractiveness of the business to potential buyers.

## Employees and the decision to sell

Managing performance in an exit planning stage is all about identifying employees who can ensure a successful exit and operate the new business. Measuring performance to current goals is not going to be sufficient.

Instead, treat this process as an unprecedented opportunity to take a fresh look at where the company is headed and how the current workforce fits in. There has been a clear shift over the past few years in the types of skills that business leaders say they are looking for. PwC's [Global CEO Survey](#) has tracked the change. At every level of the hierarchy, people are needed who can harness innovative thinking and apply the systems and tools to advance the business.

An effective workforce plan should reflect the strategic importance of talent in the business, combining the identification of crucial talent as well as skill sets to build up from within. It should also take steps to identify where to supplement immediate gaps for a period of time to help perform knowledge transfer, and whether it's necessary to hire externally to fill those niche skills that are too difficult to groom from within.

Specifically, long before a transaction is on the horizon, the plan should also weigh the impact of a sale on the employees and develop a strategy that balances retention-rewards, monetary as well as non-monetary retention strategies, such as stretch roles for key employees.

Typically, retention planning ahead of a transaction takes place on several levels, with strategies for high performers or potentials who are critical to the success of the business long term, as they are likely the individuals who will be considered lucrative to deal value and should have a place in any NewCo. Secondly, planning should consider strategies for those who are critical to the transaction and will need to be retained for some period of time post-close to ensure deal success. The more these individuals can be identified in advance, the more you can understand the impact from a retention planning perspective (both in terms of retention levers to pull and the cost).

As the strategy takes shape, performance management should focus on how the current team can deliver the potential future business, for example, by linking incentives to meeting goals across both front and back office so that employees work with each other to meet overarching company goals.

Employees are often the most valuable asset that a business has. Buyers will look particularly at the strength of management to sustain the business as well as a culture that fosters entrepreneurial talent that can drive future growth.



## Talking about succession

Many owners are reluctant to talk openly about their thoughts around selling the business. While understandable, it is a mistake to assume your decision-making will remain private. More likely it will not, which can handicap your ability to retain employees who are critical to the success of the business.

Consider an alternative approach: Identify the few individuals who will need to be involved in the process. This is important for several reasons. First, it avoids unnecessary or premature concern for other employees. Second, it is easier to manage the consistency of your story to potential investors when working with a smaller group. Finally, the people who will be critical to preparing for a potential transaction are likely the same people who are most responsible for the underlying value to a buyer.

As an actual transaction begins to unfold, communication needs will shift. A larger circle of employees may need to be involved in due diligence work. Yet, here again, knowledge should be limited to the smallest possible number of employees.

The impact of ownership succession on an organization can be positive or negative, depending on how carefully the transition is managed. Sometimes employee performance deteriorates, as a result of uncertainty and fear of change—a justifiable reaction, since jobs may be eliminated or modified during the business transition. However, business succession can also improve employee performance if the planned changes are quickly and effectively communicated to the staff.

## Develop tax strategies early

Because some of the first decisions could have far-reaching impacts, begin by putting an effective foundation in place for managing the wealth that will follow, even before an exit strategy reaches the closing stage.

Understanding the impact of the 2017 tax reform on the sale of your business is essential to maximizing tax-related benefits. Each of these issues are factors with tax consequences:

- The legal structure of the business (C Corp, S Corp, LLC, etc.)
- Whether assets of the business are sold or company stock acquired
- Whether the sale is structured as a one-time transaction or an installment sale over more than one year

Minimizing ordinary income tax treatment in favor of long-term capital gain taxation is preferred due to the significant rate differential of a top rate of 37% for ordinary income as compared to 20% for long-term capital gain. Due to the complexities surrounding the new tax law and of income tax in general, it is essential that the private business owner engage with seasoned tax advisers to understand the best possible tax outcome. In addition, depending on the structure of the transaction, the buyer can often generate substantial tax benefits (via a tax “step up”), and therefore you, as the seller, should be able to negotiate to share some of that value creation.

## Start positioning your business now

The amount of negotiating leverage the seller will have is often in large part determined prior to negotiations with a buyer. Early planning and preparation can dramatically increase that leverage. As you build your strategy, build your team and manage the process, you will be better positioned to focus on running your business as the sale process runs its course.

Effective planning enhances value in yet another way by allowing you to have the best available information to make an informed decision whether to accept an offer or to walk away. A sufficient time frame allows the company and its owner to:

- Demonstrate long-term relationships with customers and vendors.
- Institutionalize the business value. Ensure an effective management team is in place long before a potential transaction, alleviating buyer concerns that the business value might be too dependent on the owner.
- Build a comprehensive strategic plan and a defined path for growth. The ability to articulate the story clearly engenders confidence in buyers and investors.
- Put the financial house in order. Potential buyers are likely to scrutinize several years of historical results to get a better understanding of the risks and rewards associated with an investment and to benchmark for future performance. While a full audit may not be a necessary requirement from a buyer, having a respected firm put together a quality of earnings package on the historical financials signals a readiness and seriousness to move ahead on a sale.
- Create quarterly and/or monthly management reports to help a future buyer understand the metrics and performance indicators being used to manage the business.
- Develop a robust, aggressive (but defensible) operating and financial forecasting model, likely with three years of projections. An external financial adviser can help to pull this together if the business has not historically developed longer-term projections.
- Develop a story that shows how the business is differentiated. Demonstrate the quality of earnings, cash flows and sustainable performance, and anticipate the questions and concerns of potential buyers.
- Start considering who might be the ideal buyer and how they might value the business. By better understanding a potential buyer's philosophy and attitude about what drives value, a seller can better understand how to best position those attributes to maximize value.
- Evaluate the complexities of your balance sheet, legal entity structure and tax landscape, and understand the options and alternatives for various deal structures.
- Realistically understand the strengths and weaknesses of the business. The better understanding owners have of the warts (as well as the gems), the more prepared they will be in discussions with a potential buyer.
- Formulate and implement a comprehensive sell-side due diligence process that will position the owner to be better prepared for buyer skepticism, rigorous analysis and negotiations.

Each of these steps are discussed in detail in this report.

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# Understanding the buyer universe

One of the smartest moves you can make to sharpen your story is to look at your business through the eyes of a buyer.

We began to cover what's involved with this shift in *Making the decision to sell*, because we believe the earlier you step away from the day-to-day and study the business anew, the more time you have to make potentially substantive changes that add to the value of the business. In this section, our goal is to immerse you in the buyer's world so that they don't all look the same to you. The variations in where buyers find value in your business (and their operating philosophies post-close) may not loom large to you at the moment, but they could play out in ways that leave you with very different options to exit the business.

If you know you want to exit entirely, you'll likely land on a "hard auction" to attract the most buyers and weigh the best terms with the lowest risk of failure to close. Knowing what information is more (or less) valuable to buyers will help you avoid pitfalls that can delay or scupper a sale. On the other hand, you may want to maintain a role for a set time in the business and seek a sale as a means to diversify or to raise additional capital to grow, while still retaining the potential for further gains. If so, you'll want to attract investors, most likely from private equity, to act like partners in expanding the business. Which one will allow you to own more? Which one might create retention or option programs that are a better fit for your management? What is their track record in working with other companies they've acquired?

Most owners of family-led businesses who do not plan to pass the business on to the next generation will find that their only viable exit is to sell to a third party. There may be financial and practical reasons why a management-led buyout is challenging in today's capital market. And while people may talk about an IPO as an exit from the business, it's really better characterized as a capital-raising event. Going public may permit an owner to free up only a portion of the personal wealth that is tied up in the company, and a full exit may take years or may never be achieved. Corporate partnerships or joint ventures are also options to create access to capital to grow the business and may offer alternative ways to extract some cash through a dividend, for example, but offer little in the way to fully exit the business or diversify your risk.

The best choice for a private company owner will depend on many factors: personal goals, the financial needs of the owner and the business, and the state of the industry, to name just a few. Understanding the buyer universe will help you prepare for variations in how you present and guide the process toward the right outcome for you.





## Buyer types and what they may value more

A good sale process is one that yields fair value. A great process is one that is able to deliver a sale price in excess of fair value via a combination of perceived scarcity, competitive tension, solid fundamentals, strong synergy opportunities and a well-run process. The below are simply a few examples and these are just the broadest categories.

**1. Strategic or pure-plays**—Can come from your existing competitors or from a sector company looking to get a foothold in your geography or industry. Strategic buyers can also arise from existing private equity portfolio companies. Risks to post-sale integration are often top of mind while opportunities for cost savings and revenue synergies will likely factor significantly in their assessment. The higher the potential for savings and  $1+1 = 3$  collaboration, the more value they are likely to place on your business. It is unlikely that the owner stays on after the sale in most strategic acquisitions.

**2. Vertical integrators**—Can be identified by looking up and down the supply chain to build a strategic capability, often via existing customers or suppliers. A variation on the strategic buyer, these companies can often offer many advantages for a speedy and efficient process but can also create competitive challenges during the process for both seller and buyer. Owners actively managing the business are more likely to stay on, for a period, in the case of the vertical integrator.

**3. Private equity or venture capital**—Financial investors whose appetite for acquisitions and structuring flexibility has grown with the rise in equity capital available to invest and debt-financing conditions that are conducive to leveraged transactions. Nonetheless, most still plan to build up the business and exit via a sale or IPO, ideally in less than five years. Thus future synergies, potential add-on acquisitions, cost savings opportunities and capabilities of the management team to meet that exit-driven goal are often standout differentiators.

## The strategic buyer

The strategic buyer seeks a good fit with some aspect of the seller's business. They are frequently in the same business and are trying to access new markets, obtain talent, increase market share, or acquire expertise, patents or company know-how.

Oftentimes, this decision stems from a potential buyer's analysis that it is cheaper and faster to buy an existing company than it is to build or develop their own from scratch. Yet the analysis won't stop there; cultural factors can make or break the integration post-transaction. Thus, strategic buyers will also consider retention and loyalty programs. We recently took a reading of how active corporate dealmakers assess the value they achieved from transactions, and retention was seen as a key determinant success. Our report found that most executives who felt significant value was destroyed in their latest acquisition also said they lost more than 10% of key employees following the transaction.

When the synergies are significant, the strategic buyer is often willing to pay more, especially when those anticipated benefits are specific to the buyer compared to others. In general, synergies are most potent when they can be realized quickly, carry less risk as well as create cost savings. Vertical and horizontal integration strategies effectively executed can open up significant value creation opportunities for buyers. When considering a strategic buyer, you will want to anticipate possible synergies in order to capture the potential value associated with them.

Here are some of the advantages and disadvantages of selling to a strategic buyer:

### Advantages

- Likely to provide highest valuation in the near term, if convinced by the potential for cost savings and synergies
- Likely to enable the entrepreneur to completely walk away (i.e., obtain the greatest liquidity)
- Typically, strategic buyers are very knowledgeable about the business, facilitating due diligence and closing
- Less likely to be constrained by financing contingencies, which also facilitate due diligence and closing

### Disadvantages

- Management may lose autonomy, lose their job or have their roles diminished
- Possible negative impact on culture and morale
- May affect customer loyalty
- Potential leakage to those in your current ecosystem (suppliers, customers, etc.)
- As the owner will typically depart, future upside value is sacrificed (unless there is significant stock or earnout consideration)
- Strategic buyers don't necessarily subscribe to the private equity playbook for acquisitions. Some move more slowly, raising risk of the acquisition being caught up in bureaucratic delay or "decision paralysis"
- Concerns with providing access to competitive information, should the deal fall through

### *Our Roadmap for an IPO report*

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## The private equity buyer

By nature, the private equity buyer hunts for opportunities to invest in companies with superior management, growth and returns profiles. The fund seeks to provide financial support to the business and exit for a profit in the shorter-to-medium term. Private equity buyers are sophisticated investors that can offer a range of alternatives to a seller seeking a creative structure.

The size of the private equity market has grown substantially in recent years, surpassing \$2 trillion globally in “dry powder” capital that’s available to invest. Demand has significantly exceeded the supply of high-quality investment targets. These factors have considerably enhanced private equity’s competitiveness in the deals market. PE firms are also starting to take a longer term investment horizon, and holding periods are increasing. Part of this is due to the higher valuations they have paid in recent years, but also a fundamental shift in the business model to more patient investing.

The most marketable businesses to a private equity buyer tend to be those with solid and recurring cash flows, a defensible market position, strong cash conversion and healthy organic and/or inorganic growth prospects. Strong credit markets and ability to leverage are additional factors that enhance financial buyers’ competitiveness.

They may not be focused on synergistic opportunities from the immediate transaction if the company is intended to be a platform for an industry acquisition strategy. Once a portfolio company is acquired as a platform, private equity financial buyers become more like strategic buyers in their approach and will look for other “bolt-on” acquisitions.

Though distressed funds constitute a smaller segment of the market, depending on the reasons for the company’s troubles, operationally minded private equity buyers may be interested in pursuing turnaround situations or deals with more complications.

To achieve their targeted investment returns, they will generally finance the acquisition with significant leverage (additional debt). As a result, they are more sensitive to issues such as management quality and depth, sustainable EBITDA (earnings before interest, taxes, depreciation and amortization) and free cash flow.

Here are some of the advantages and disadvantages of selling to a private equity buyer:

### Advantages

- More likely to provide owner with ability to stay on for a set period, diversify some of their risk and potentially capture additional returns. This is known as “taking a second bite of the apple”
- Provide access to “deep pockets” for acquisitions and other growth initiatives
- Current management/shareholders may retain upside potential via equity in the new company
- Ample “dry powder” or unspent money across the private equity landscape (mid-market firms and larger ones) as well as robust financing markets
- Current management/shareholders will likely maintain significant involvement in direction and operations of the business

- Entails relatively less business disruption and impact on customer loyalty and employee morale; business continues to be private and independent
- Likely to be flexible on structuring the transaction, i.e., how the seller exits the business

### Disadvantages

- Likely expects continued involvement of owner in business in the short term. Heavy debt load can transform requirements on management as margin for error shrinks
- Upside potential is dependent upon strong management direction and growth
- Heavy financial and operational reporting requirements (although this is largely good discipline, as the demands can grate on a former owner)
- May take longer to fully understand the business during the exit process

## Keeping your eye on the goal

Finding the right buyer for your business is possible only when you have thoroughly considered your objectives and priorities, both business and personal, and both financial (liquidity, sale price, taxation/estate planning) and non-financial (succession, legacy and reputation, employee and stakeholder concerns, family dynamics, and other special interests). The right buyer is often the one who will attach the maximum value to your business. But choosing the deal that's right for you may not be all about money. If you wish to protect your legacy, you might look for a buyer who will keep your name on the door, preserve your culture and community commitments, and who will retain key employees or not close your plant and take production to another country.

Only you can decide which of the criteria are the most important in your definition of value. While such a decision may not be simple or straightforward, gathering information on the pros and cons of each option as well as the likely process that will need to be undertaken is a smart way to help you reach such a determination.



# Preparing the business for a sale

Laying the groundwork for the successful sale of a business represents one of the most significant challenges in the life cycle of any company, and often simultaneously for the owner. Much of the difficulty lies in balancing two competing priorities. On the one hand, a seller wants to realize the highest value possible and to commit significant effort to steer the process carefully. On the other, day-to-day operations must remain sharp and managers focused.

While no one-size-fits-all answer exists to help owners manage the challenge of simultaneously running a business and managing a sales process, careful preparation goes a long way.

## A successful sale builds from a constructive mind-set and extends through a series of disciplined steps

Telling the story of the future of the business is the foundation to a good exit process. The right information—interpreted and presented correctly and directed strategically—unlocks the basis for value and builds confidence in the projected performance.

### 1. Align the business objectives with sale objectives

*The sales process is disruptive for a variety of people who make your business valuable.*

### 2. Select key management team participants and retain trusted deal specialists

*Demonstrate the depth of management and deal capabilities to move to a close.*

### 3. Prepare financial reporting

*Monthly reporting, audit statements and tax filings drive the details that both the buyer and seller need to know.*

### 4. Get ready for deep dives

*Unpleasant surprises can quickly derail buyer-seller momentum and deflate perceptions of worth.*

### 5. Build a better data room

*Demonstrate that the company has the tools, resources, systems and abilities to analyze the business and track the information needed to grow and safeguard profits.*

### 6. Develop projections that tell a credible and compelling story of future growth and profitability

*Your credibility is likely at its highest if you present normalized quality of earnings analysis first.*

### 7. Identify buyers and what's important to them

*Look for synergies, cost savings and opportunities that could be accelerated by a new infusion of capital.*

### 8. Evaluate potential tax and transaction structuring alternatives and review the legal landscape

*Are you selling assets or stock? Know the trade-offs to structuring options.*

### 9. Review human resources—and refine their direction

*All buyers will want to know about retention and severance terms.*

### 10. Determine—and execute on—a specific sale time line

*Act with precision once the decision to proceed has been made.*

## One: Align the business objectives with sale objectives

Once the decision has been made to sell, the business switches to a faster gear. If attention to the day-to-day operational matters gets pushed aside, the business will likely suffer just when optimal performance is critical. At the same time, you'll need to step aside and think through everything that the sales process will impact, from other shareholders and employees to lenders, suppliers, customers and competitors (who may become a buyer).

All the key players on the team must pull in the same direction to decrease risk associated with closing a sale. Conflicting signals compromise credibility and effectiveness by creating confusion and doubt.

Where shareholders and management are not the same individuals, their interests during a sale transaction may not always align perfectly. Key employees are usually your most important asset, and their treatment and retention should be a paramount focus to ensure a successful process. In our experience, it's also important to capture their input and address any concerns early on. Ample preparation time enables you to maintain control of the process and to better anticipate and actively get ahead of potential deal issues and keep the sale process on track.

As thinking turns to action, owners can focus their considerations on the right time to sell with two thoughts in mind: (1) It is always best to avoid letting events dictate when you must sell and (2) the best way to avoid dictation by events is to maintain readiness and agility if an excellent opportunity arises.

The actual events triggering a sale can be a combination of market and personal conditions, such as a highly favorable offer or a generational change in the business.

At the end of the day, owners should always regard the possibility of a sale as one of their alternatives and be prepared by making sure everything they do generates and creates shareholder value—whether they are selling or not.

## Two: Select key management team participants and retain trusted deal specialists

In preparing for a sale, owners face one of their most sensitive and critical tasks: determining their so-called circle of knowledge, or those key individuals at the company who need to know about the plans for the future of the business.

For owners, the art lies in forming the optimal internal team. The right people must be identified to gather information and interact with buyers. At the same time, the group must be narrow enough to control the consistency of the seller's message and minimize overall distraction from day-to-day operations.

Generally, it's best to keep the group as small as possible—typically, five to ten individuals. Each will have a role to play and should be able to interact independently with potential buyers as the sales process advances. A “need to know” determination will help minimize errant communications and business disruptions. However, the owner must strike a balance with the necessity of having the essential business knowledge on the team for



buyer interactions. The circle may expand as more and more internal leaders are needed to meet with buyers and demonstrate the depth of management. A seller must show his team has created institutional value for the business, and that management is strong: they have clarity of strategy, tactics, judgment and metrics. Attaining this level of uniformity around key points for buyers can be greatly augmented by coaching from an adviser.

Given the limited bandwidth of a typical seller's resources, the nuances of the process and the fact that the sale often represents both a life-changing and once-in-a-lifetime event for owners, experienced external advisers—lawyers, accountants and investment bankers—can be critical for a successful outcome. Good advisers can smooth and accelerate the process while helping accurately recognize value and provide insight and guidance in complex areas. They can provide bandwidth and surge support when internal resources are stretched or limited. Finally, the objectivity that advisers provide can be crucial to owners faced with many emotional, highly subjective decisions. Chemistry and trust are key factors give the amount of time spent with advisers.

A successful sale builds from a constructive mind-set and extends through a series of disciplined steps.

### Three: Prepare financial reporting

Ideally, the sale or divestiture plan will evolve neatly out of a diagnostic overview of the business conducted well before a sale. We discuss aspects of a pre-sale checkup in detail in the first section of this report, Making the decision to sell. In brief, the purpose of early preparation is to create time for corrective actions that make improvements that a buyer will appreciate and want to pay a premium for.

Closer to the time of a sale, a second diagnostic sets the stage for sale. Sometimes referred to as sell-side due diligence or quality of earnings (QofE) report, this analysis builds off the company's financial statements—monthly reporting packages, audit statements and tax filings, as examples—and captures how a buyer will view “normalized earnings” and cash flows during diligence. A QofE analysis is standard in most divestiture processes these days, and it also helps the seller organize the data and accompanying story and drives the foundational thinking into the details that both the buyer and seller will need to know to complete an effective transaction. Specifically, a QofE analysis focuses on determining the underlying level of earnings generated by the business by eliminating distortions from the actual reported results and establishing a maintainable earnings trend. The review considers non-financial debt impacting future cash flows, off balance sheet items, commitments and contingencies, or significant items that may affect value and crystalize in the near future. Sell-side due diligence is no longer optional.

You want to be aware of any issues to ensure you are properly prepared before the buyers' own due diligence begins.

Further, the company will need to develop a robust set of financial projections on both operating and financial metrics that will go beyond the one-year budget most companies typically have in place. Instead it will show a minimum of three years and up to five years of financial forecasts.

Management's presentation of the business's historical and projected financials should be able to highlight performance details, establish a normalized historical run-rate of performance, defend your story and company projections, and explain any complexities or hidden opportunities to keep buyers on track and address their expectations.



## Four: Get ready for deep dives

For the seller, the qualitative framing finally turns toward simple quantitative questions: What does my business translate into in dollars and cents? How can I even think about selling without knowing the worth beforehand? Should I just get a valuation and ask buyers to pay based on that price?

Of course, the answers aren't as straightforward as the questions. Market valuation benchmarks can sometimes set false expectations on both the high and low sides.

Setting appropriate expectations begins by understanding the concept of fair market value—the price at which a trade would happen between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the facts. At its simplest, a business is worth its estimated future cash flows discounted to their present value. That being said, valuation is as much an art as it is a science, and a number of variables goes into a buyer's perception of value.

Comprehensive sell-side due diligence will take much of the mystery out of valuation exercises. It should reflect considerations of the key drivers of the business from both the seller's and buyer's perspectives. The process (1) helps identify areas that have deal and value implications and (2) prepares and coaches management to appropriately address the issues with potential buyers. Concise, knowledgeable responses are required to answer fundamental buyer questions; anything less can detract from value and from the overall transaction's likelihood of success. Areas of focus typically include understanding the quality of historical earnings, the components of both historical and projected business trends, key customer and supplier relationships, working capital and capital expenditure requirements, strength of the management team, potential synergies, and technology and intellectual property issues, among others.

Many of these areas can be addressed initially by a high-level management presentation or, occasionally, with a Confidential Information Memorandum (CIM). The CIM provides a detailed description of the business, future opportunities, and historical and projected performance to educate acquirers on the benefits of owning the business. Ultimately, however, owners will need to assemble information—usually referred to as a data room—that fully supports the story of historical and projected performance.

Thorough sell-side due diligence can help avoid a range of problems, including sellers being blindsided by unanticipated issues, potential post-closing disputes and simply failing to close the deal. Ultimately, the appropriate positioning of the information gathered during the sell-side due diligence process often helps owners gain a higher sale price.

## Five: Build a better data room

The data room typically brings together comprehensive information covering financial results, key business drivers, legal affairs, organizational structure, contracts, information systems, insurance coverage, environmental matters, and human resources issues such as employment agreements and benefit and pension plans. Information should start being pulled together as soon as the CIM has been drafted for distribution to prospective buyers because the data room ultimately supports much of that document.

The extent of information and level of detail in the data room should be balanced, providing enough information to enable buyers to determine value and to complete due diligence. but also limiting the amount of sensitive or competitive information disclosed to anyone other than the ultimate purchaser. Often, striking the right balance requires discussions between sellers and their advisers.

A comprehensive, well-thought-out data room demonstrates to buyers that a company has the tools, resources, systems and abilities to analyze the business and track the information needed to grow and safeguard profits. Conversely, a poorly assembled data room with significant information gaps signals potential buyers that there may be operational or other data weaknesses that could dampen their views on value.

Today, data rooms are almost always online information hubs (rather than actual rooms in attorneys' offices) that present the key information a buyer needs in order to begin judging value and underlying interest. Generally, online data rooms speed the process, lower costs and better manage the information flow by, among other things, differentiating access restrictions by buyer categories to block strategic buyers from sensitive competitive information while opening the same information to financial buyers and tracking review patterns and questions from buyers.

## Six: Develop projections that tell a credible and compelling story of future growth and profitability

The more thorough your due diligence, the better positioned you'll be to present a compelling case for your business in the future. Most buyers expect three to five years of financial projections. These should be carefully aligned with the business plan of the business. Moreover, they should reflect a financial performance that captures the metrics most important to buyers and highlights how your business makes money.

A company's historical and projected financial results as well as anticipated future events—good or bad—also affect value perceptions. And given the number of variables and the importance of information, valuation and financial due diligence should be viewed as complementary, interrelated and iterative tasks.

In addition to discounted cash flow analysis, major valuation methodologies used by buyers include comparisons to similar recent transactions, the public market pricing of similar companies and the value that could potentially be derived in a leveraged buyout. However, all of these rely heavily on the assumptions applied.

Market valuation benchmarks can sometimes set false expectations on both the high and low sides.

Other variables figuring prominently in the overall picture of worth include the management team's depth, strength and diversity of customer relationships. Evaluations can also crystallize around the company's stage in its life cycle, comparable growth rates and pre-tax margins, overall opportunities and risks in the company's industry, for example, and be influenced by current environments for financing and mergers and acquisitions.

At all times in the evolving sales process, the seller must build strong yet credible messages around quality of earnings underpinning projections for the future and develop a dynamic due diligence process that best prepares it for buyers' possible skepticism, rigorous analyses and intense negotiations.

## Seven: Identify buyers and what's important to them

It has been said that beauty lies in the eye of the beholder, and often financial worth does as well. Transactional value depends to a great degree on who's doing the purchasing: buyers interested in potential synergies and cost savings or private equity sources seeking an anchor investment and focused on optimizing the financing structure and putting their capital resources to work. By better understanding a buyer's philosophy and attitude toward value, a seller can begin to understand how this outlook applies to the attributes of the business and its emerging valuation. An external market perspective also prepares owners to present the most credible and most compelling picture of future growth and profitability.

(For a full discussion of buyer categories, advantages and disadvantages, see [Understanding the buyer universe](#).)

Strategic buyers often emerge from the same industry and seek a good fit with some aspect of the seller's business. For instance, this may include accessing new markets, increasing market share and acquiring expertise, patents or know-how. When the synergies are significant, the strategic buyer is often willing to pay more. A seller will want to anticipate those synergies in order to capture its share of the potential value. Telling the story from the buyer's perspective can be very effective; not only is it helping buyers see the synergies, but it also makes them feel like they are in the pole position.

If the expected buyer is strategic, then the story often deploys an understanding of the benefits and costs of integration, including the potential opportunities, inherent sales and distribution channel synergies, purchasing power increases, production and administrative efficiencies, and working capital improvements.

Other types of buyers (particularly private equity) typically hunt for investment opportunities in which they can use the benefit of significant financial leverage to improve returns, provide financial support for the business as it pays down debt and grows, and then exit their investment for a profit in the short to medium term. They are usually highly sophisticated and flexible in terms of deal structure and are consummate professionals on execution.

For this type of buyer, the most marketable businesses tend to be those with solid cash flows, strong management teams, growing markets, a defensible market position and lower capital expenditure requirements. If the likely purchaser is private equity, the story may focus on opportunities that could be accelerated and captured by a new infusion of capital, such as add-on or tuck-in acquisitions or new product launches.



## Eight: Evaluate potential tax and transaction structuring alternatives, and review the legal landscape

While tax structuring grows from a seller's goals and a buyer's goals, from the legal form of business to evolving tax laws, the success of the approach depends on anticipating the transaction, establishing objectives and evaluating the economic and tax risks. Given that there are many variables and potential outcomes.

In general, first recognize that buyers typically prefer asset-based transactions for an appreciated business, so that the assets will receive a fair market value basis for tax purposes that can be recovered through future depreciation and/or amortization deductions.

Beyond that, tax approaches vary with the form of business, and can often be complex and require planning. If the business to be sold is owned by a C corporation, an asset-based transaction may result in taxation of both the corporation and the shareholders. As a result, owners typically prefer to sell shares in the C corporation and incur only one level of tax.

If the business is held by a flow-through entity—such as an S corporation, partnership or limited liability company (LLC) taxed as a partnership—gains generally are taxed only once: at the owner level. The owner's tax liability generally depends on the character of the assets sold, which often drives complex tax considerations. For instance, shareholders of an S corporation can avoid an increased effective tax rate simply by selling their S corporation shares and recognizing capital gain that is taxed at a 20% federal income tax rate, assuming the shares qualify for the long-term capital gains tax rate. However, the buyer will not receive the desired asset basis step up on a share-based sale and may insist on an asset-based sale. Often, buyers agree to an increase in purchase price so as to take into account the incremental tax liability associated with an asset sale over taxes that would be incurred on a share sale.

If the buyer and seller agree to an asset sale but find that a legal transfer of the assets is too costly or administratively burdensome, the buyer and seller of an S corporation can achieve the federal income tax consequences of an asset-based sale and the resulting step up to the buyer by making a section 338(h) (10) election on a legal sale of S corporation shares.

Finally, while legal issues are not usually a focal point in a sell-side due diligence report, reviewing the legal landscape of the business is an important part of pre-sale preparation. The review should encompass customer contracts, vendor arrangements, employee matters, potential or actual litigation, LE structure and related party transactions. The data room should have supporting documentation as part of the effort to help buyers conduct their reviews quickly.

## Nine: Review human resources—and refine their direction

People-related considerations stand out among the reasons that mergers and acquisitions fail to meet expectations. Issues range from the talents of the executive team and how the executives fit into a new owner's plans to the financial implications of compensation and benefits packages. Understanding these components and doing advanced planning around them can increase the odds for success.

Owners should enter negotiations with an understanding of the tax consequences of a transaction, including the different implications of an asset-based or share-based transaction.

Once the full human resources financial picture is understood, refinements can begin to anticipate potential buyers' concerns and to address weak points. Planning should begin with an inventory of the company's compensation and benefit programs, including the financial implications of the programs. This includes variable and incentive compensation programs, severance terms, retirement and health and welfare plans, equity compensation programs, and any benefits or special arrangements for or with executives. The executive team is especially important in light of a sale: in terms not only of its talent and the likelihood that key people can be retained (or others separated) but also of the financial implications of either severing or continuing the relationship.

All buyers will want to know about retention and severance terms, obligations to keep executives for certain periods of time, payments to executives and employees triggered by the transaction, potentially lost tax deductions on deemed parachute payments imposed by Internal Revenue Code Section 280G, collective bargaining agreements, and defined pension benefit plans, as well as any other unfunded retirement obligations.

The equation can grow more complex if business units are carved out and sold apart from the whole, when human resources and benefit costs allocated to these units may not reflect expected costs on a stand-alone basis.

Beyond the inventorying of human resources programs and costs, owners need to assess how the total human resources picture and associated compensation and benefits programs will affect different types of buyers throughout the transaction life cycle, extending even after closing. A buyer in the same industry may want to retain a business's head of sales or operations but not the chief financial officer or CEO and may want to integrate the seller's employees into its own benefit programs. Further, a strategic buyer is more inclined to look for synergies and opportunities for further cost savings.

A financial buyer, which often seeks a plug-and-play deal (that is, a minimal need for business or management changes post-close), will want to lock in and incentivize an executive team to ensure continuity. Planning also varies by deal and industry: Underfunded pension plans that will need large cash contributions in the short term may take priority in one case, while the costs of settling existing equity compensation and stock options loom large in another—for, say, a fast-growth IT start-up.

Owners can go a long way toward smoothing their path to sale by understanding their own human resources environment early on and taking any needed steps to properly communicate their program's historical and future costs and, when possible, to realign elements that would facilitate the deal.

## Ten: Determine—and execute on—a specific sale time line

A seller needs to take steps to create a sense of scarcity on the part of buyers—that is, convincing suitors that the investment opportunity for the business being sold is unique in some regard and creates distinctive value in a buyer's hands and competitive process. The process must be designed to keep up a sense of urgency with buyers right through to closing. All in all, the objective is to keep value high and avoid the deal fatigue that results from a drawn-out process. In addition, value cannot be maximized in a vacuum: A seller has to understand the courting party's agenda, value drivers, and deal-making and deal-breaking issues.



# The deal process: moving through negotiations to a successful close

You've made the decision to sell. You've considered the possible types of buyers and the type of sale that will work well for your business. You've considered the value of the business and geared up for an actual sale process, building a package to present to potential buyers. Now you're ready to approach potential buyers and begin the actual sale process.

At this stage, it's critical that a seller actively exerts control over the elements they can control. This seems like a simple concept, but it is a mandatory, deliberate commitment. This installment explores ways you can maintain control over the sales process while retaining the crucial advantage of speed—the two factors essential for an optimal outcome.

## Three pre-negotiation checks

### 1. Line up all internal resources and outside expertise

Private company business owners often underestimate how demanding the sale process is. In doing so, two things can go wrong: either the owner may not commit enough time to adequately maintain control over the sales process—such as by ensuring timeliness and properly managing information flow—or the owner may become so preoccupied with the sale that inadequate attention is given to running the business. It is critical not only to plan for the internal resources needed to support the transaction but also to supplement the internal resources with resources from outside advisers as needed. Key members of the owner's team already have their "day jobs" and likely numerous side projects, too. But they should be prepared (and incentivized) for the extra work that inevitably accompanies the sale process.



A team of trusted advisers and deal specialists can provide insight, objectivity and guidance in many complex areas. Such areas may include:

- Legal
- Deal structuring from a tax perspective
- Investment banking/capital structure
- Valuation guidance
- Telling the story, including extensive marketing materials and presentations
- Buyer solicitation and management
- Overseas investors solicitation and management. Many foreign companies and sovereign wealth funds view the US as a growth opportunity and/or a more predictable market from an investment risk perspective
- Overall process management
- Negotiation support
- Sell-side due diligence
- Accounting expertise
- Personal or estate taxes
- Specialty advice—for example, regarding environmental issues, risks or industry trends

To effectively use advisers, an owner must involve them early enough in the process to enable them to help influence the outcome. As often is the case, the further an owner advances into a potential deal, the more limited the options become.

## 2. Structure the deal from a tax perspective

Sellers can lose significant value when entering the negotiation process without having already considered the tax structuring options available.

Too often, a sale process has already reached the letter-of-intent stage before tax advisers are consulted. At that point, many areas have already been preliminarily negotiated and expectations set, and tax-efficient alternatives may no longer be options. The owner may lose the chance to present beneficial structuring alternatives to the buyer as well as the ability to capture the value inherent in any such change or structure demands of the buyer. Furthermore, changing the tax strategy at this stage may jeopardize the speed of close and put the underlying transaction itself at risk.

Developing tax strategies is one of the important ways an owner can remain in control of the selling process. Do the work upfront to understand the different impacts of an asset deal versus a stock deal and consider them in communications and negotiations up front with buyers. Keep potential buyers' motivations top of mind when developing tax strategies. A regular example of this could be the 338(h)(10) election with a stock deal, enabling a buyer to treat the transaction in a more favorable way for them and creating a tax value benefit that can be shared by an educated owner. Particularly in light of the recent tax reform, different buyers (e.g., US vs. non-US) may have different objectives, and understanding your likely buyer's motivations will aid the sales process. You will have to navigate the complex mix of tax rates and the specific tax attributes of both the business owner and the business to be sold when developing a tax strategy.

An effective process protects confidential information, maintains speed by avoiding unnecessary and repetitive explanations and meetings, enhances buyer interest, allows increased insight into the buyer's motives and key interests, and—ultimately—enhances value and gives the seller control over the process.

### 3. Determine a specific sales time line

Before potential buyers are contacted, you should develop an execution plan and a timeline to address the timing and development of the following items/actions and match each with their respective responsible parties:

- Strategic objectives and process management plan
- Drafting of company descriptive materials
- Performance of sell-side due diligence and preparation of a comprehensive data room
- Preparation and presentation of the story of the business and its management
- Buyer due diligence
- Negotiations, legal documentation and closing

## Courting potential buyers and managing the information flow

Your company's descriptive materials and data room are ready—and you're prepared to begin negotiating with potential acquirers. Success from this point forward depends in large part on a balance of speed and control over the process. Part of this control involves carefully managed interactions with potential buyers.

### Identifying and connecting with potential buyers

By this point in the process, you will have already evaluated the likely potential advantages and disadvantages of the various purchasers and how the differences will likely affect objectives and potential outcomes.

This can be a simple process for some companies but in cases where the likely buyer is not obvious and the company's lacking the necessary transactional expertise, it usually makes sense to engage an investment banker who will proactively work to identify potential acquirers across a wide range of regions and similar or tangential sectors. It should be noted that as opposed to many other advisers who may work at an hourly rate or for a fixed fee, an investment banker often requires a retainer and a success fee based on a percentage of the proceeds from the transaction, but the intent is to create a compensation structure that aligns the adviser's and the seller's interests.

Depending on the number of potential acquirers, a seller may opt to contact a handful of specific buyers individually or to arrange an auction (a process by which the sale of the business is marketed to multiple parties). Most sellers will try to focus their efforts on 25 or fewer potential buyers and then narrow their focus to those who are the most serious and whose proposed transaction terms are likely to be the most attractive. In today's market, flush with private equity capital, a well-run business will likely have a range of interested parties. An investment banker may break the process into segments to optimize the flow of information throughout the selection and preliminary negotiation period.



Once the seller has identified the initial pool of potential buyers, it's time to reach out to them and call out at a high level why the company is attractive. If potential buyers want to learn more about the company, sellers should have them sign a nondisclosure agreement (NDA) before further information is provided. Once the NDA has been signed and the seller is legally protected, the key then becomes knowing how much information to provide and when to provide it. NDAs aren't a fail-safe—information can leak into the market or the company ranks—but you need to set a strong commitment to mitigate the risk.

If the potential buyer pool has been narrowed down to one or two parties, the seller generally gives those potential buyers much of the information they request during a confirmatory due diligence stage. But in an auction, the seller needs to manage the information much more carefully until the number of potential buyers has been reduced and the unqualified ones are eliminated. Value and certainty of close are two key considerations when narrowing the field.

### **Managing the flow of information**

An effective process protects confidential information, maintains speed by avoiding unnecessary and repetitive explanations and meetings, enhances buyer interest, allows increased insight into the buyer's motives and key interests, and—ultimately—enhances value and gives the seller control over the process.

An increasingly common way for owners to do this is to hire outside experts to conduct due diligence on the company before buyers come in. The third installment of this series, *Preparing the business for a sale*, discusses the wide range of information expected by serious buyers.

The extent of information and level of detail that is shared should be balanced, providing enough information to enable buyers to determine a fair value but also limiting the amount of sensitive or competitive information disclosed to anyone other than the ultimate purchaser. But how is that balance achieved? And what information should be disclosed to whom?

## **An effective and well-written CIM can be a strong facilitator in the selection phase of the selling process.**

The confidential information memorandum (CIM) aims to describe the company's past, present and future potential. It should present an upbeat but defensible description of the company together with sufficient financial information to enable potential buyers to come to a preliminary valuation. Past performance as well as near-term financial projections (current and next year) is usually the key underpinning to future confidence.

The CIM contains an overview of the business, key growth opportunities, market share data, background on management and competitive position. It also contains details on historical and, in most cases, projected financial performance, product and business descriptions, operations, and sales and marketing. An effective and well-written CIM can be a strong facilitator in the selection phase of the selling process, while providing the seller with an opportunity to add appropriate context to potential negative elements of the business. Depending on the nature of the likely purchaser, a seller may not need to prepare a full CIM but should nevertheless be prepared to assemble a comprehensive financial information pack and data room to connect with plan with the relevant performance metrics. An investment banker will typically take the lead role in drafting the CIM with assistance from management.

### **Moving from the general to the specific**

The CIM is typically provided along with a letter containing specific bid instructions to potential buyers who have expressed interest in learning more. The bid letter will set forth the timeline and details of the process and usually request a preliminary indication of value in addition to any other information deemed necessary to the decision-making process. Such information might include:

- The structure of the deal (i.e., stock or asset deal)
- Why the buyer thinks the two of them make a good match
- How the buyer plans to run the business going forward
- The buyer's plans for existing management
- How much time the buyer would need to perform confirmatory due diligence
- What contingencies might be attached to the bid
- How the buyer would finance the deal
- Any contingencies or gating factors to closing a deal

The bid instruction letter should generally allow a limited time by which interested parties must respond with their preliminary indications of value and other conditions. Again, if the owner is adequately prepared, it's generally best to move fast. From a process perspective, you will have the most leverage at this point, assuming multiple parties are interested in competing for the company. Some buyers may ask for (or demand) exclusivity to continue in the process. You and your advisers will have to carefully weigh a request like this.

At the end of the stated period, you should hopefully have received responses from a subset of those who received the CIM, with a range of indications of value. You may wish to disregard those bidding below an acceptable minimum or may decide to keep some of them to enhance competition. In a robust market reflecting strong competitive bidding among buyers, the seller may be able to guide to a quicker binding offer date.

## Managing access to the virtual data room

Potential buyers kept in the process will be invited into the data room, which is now almost always being done online.

You may not want to make all information available from the beginning; instead, you may prefer to withhold more sensitive details until later in the process, when the pool of interested parties has narrowed again. In some instances, competitive or regulatory constraints may require the use of a “clean room” to ensure that sensitive information is not shared. Some sellers decide to wait until buyers themselves ask for certain information before providing it—although this approach generally leads to a poorer control dynamic around the process.

## Management presentations

As the pool of suitors narrows, owners will invite them to a face-to-face meeting with management.

The management presentation (which typically lasts two to four hours for each potential bidder) will expand on information in the CIM and give buyers opportunities to ask questions. Generally, you should try to limit the amount of management access provided to buyers as a way of controlling the process as much as possible and to allow management to continue focusing on running the business. Depending on the nature of the business, many prospective buyers will also want a “site visit” at or around the time of management presentations.

## Maintaining control as the stakes get higher

The final two or three bidders will likely be given full access to the data room, along with a seller-friendly draft of the purchase and sale agreement for their markup and comments. Drafting the agreement instead of waiting for the buyer to do so allows the owner to maintain control over the process in several ways. You can set the tone while gathering insight into how each buyer will react or respond to specific provisions in the agreement. For example, one buyer may offer a higher price than another, but the terms may be less favorable; knowing the terms up front gives you greater—and earlier—opportunities to prioritize price and various terms while moving from negotiation to closing. Note that although buyers will respond with their markups during the bidding process, the final bidder, once selected, will also almost always raise additional comments and negotiating points.

## Making the choice

### It's not as simple as price

On the surface, price may seem to be the easiest way to compare offers. But generally, there are three primary areas to consider: price, terms and certainty to close. You will have to determine which area is the most important to meet your objectives. It's rare for one buyer to stand out from the pack in all three.

- **Price**

Not every dollar is equal. For example, a cash purchase price is generally preferable to a purchase price in stock. Earnouts (any additional future payment, typically based on a business performance target) may raise the price yet also introduce an element of risk for the seller. Work closely with your advisory team to understand the real value of consideration components. Be prepared for adjustments to the purchase price due to any changes in the net working capital (cash and operating liquidity, e.g., accounts receivables) or debt (and debt-like) positions of the business since the sell-side due diligence report, as these negotiations will also take place before the closing.

- **Terms**

Terms that are considered the most important differ on every deal and with every seller. Terms could include non-compete consulting arrangements, management team continuity, customer and community commitments, continued employment of family members, and timing of the signing and closing. You must decide which terms are most important to you. It will help differentiate between bids.

- **Certainty to close**

Given the effort you've undertaken and the resources you've expended as a seller, you should consider the bidder with the greatest certainty to close. Things to bear in mind include the bidders' financial wherewithal, their reputations in the marketplace and whether they have the ability logistically to get a deal done. If you're not confident that the buyer whose price and/or terms you most like can also follow through to a close, you should be very hesitant to sign a letter of intent and provide exclusivity.

### Letter of intent

Once you've settled on your final bidder, you'll typically draft a letter of intent (LoI) that sets out the key terms at a high level. Although an LoI is non-binding, it can be helpful in laying out a baseline understanding of key terms to help move the parties closer to signing. If many of the key areas have already been addressed in the letter, the final bidder may simply confirm certain terms and ask for a period of exclusivity to finalize any remaining due diligence with respect to a wide range of areas—such as financial, legal, environmental, risk management, human resources and tax issues—while simultaneously negotiating the purchase and sale agreement. The exclusivity period can typically range from 30 to 90 days, with 45 to 60 days the norm. As a rule, buyers want longer exclusivity and sellers want shorter, but keeping the buyer on an accelerated path helps mitigate risk and reduce potential business disruption.

Once you've selected a final bidder, much of your leverage dissipates. That's why it's the most important decision in the process.

## Closing the deal

### Work through the final approvals needed to close

With the Lol in hand, your attention will turn to clearing any remaining approvals required to close the transaction, a process known as “sign to close.” They can include third-party approvals that relate to antitrust, financing or a union, or they will involve negotiated conditions that need to be satisfied and delivered before a close; such as achieving a specific target or event, an environmental impact report or an audit. Approvals can take a range of time to clear. For example, transactions of a certain size require antitrust approval from the government. If you’ve prepared well, there shouldn’t be surprises. You and the buyer will most likely work through meeting the approvals together. Additionally, seller may be asked for help from you with integration planning and preparation. At this time, the seller is also prepping for final financial reporting at close and working capital negotiations.

### Negotiate clauses as a block instead of clause by clause

When negotiating the sale and purchase agreement (SPA), make sure you understand all the issues the buyer may have raised so that you don’t get picked apart bit by bit (referred to as death by a thousand cuts). Once you know the factors that are important to the buyer, you can compare them with the factors that are important to you and devise a negotiating strategy accordingly. There are a significant number of possible negotiating points, such as indemnification, warranties and purchase price adjustment clauses. Be prepared for a lot of horse trading, but you can define the limit lines beforehand and communicate them early in your draft of the SPA. Deliver your construct to buyers for their comments, not vice versa.

### Don’t underestimate the value of a seasoned deal attorney

It is essential for owners to work closely with their mergers and acquisitions counsel to understand all the legal aspects of the SPA. Most sellers get out in front and provide interested buyers with a draft SPA and request comments and revisions so that these can be evaluated and taken into consideration in the overall evaluation of the bids. Buyers often take unreasonable positions in negotiations. Under pressure to move forward, you may be tempted to accept those positions, to assume unusual exposure or to forgo a benefit that should normally be yours. Based on their experience in similar situations, advisers can provide objective guidance as to whether or not the requests are reasonable. And they can assist you in deciding which terms to accept, when a compromise is appropriate and when you should adamantly stick to your position. Legal terms and conditions have economic impact, and good lawyers can help you prioritize and fine-tune the final agreement.



## Know when to walk away and when to take the deal

As the SPA is finalized, negotiations will frequently boil down to a handful of key items with each side fixed on a position and hesitant to compromise any further. It is typically the toughest step in the negotiating process because almost every offer will require you to accept some terms that, at the outset, you did not expect to have to accept.

Perform one last gut check:

- Are the suggested terms too onerous and indicate your objectives at the outset can no longer be achieved?
- Has the trust between the parties eroded through repeated retreading of previously agreed terms?
- Do you foresee a poor relationship with the buyers post-close, so much so that the required partnering will be difficult to achieve?

If the answer to any of the above is yes, you may find you're not able to ultimately consummate the deal. However, deals are by nature products of compromise. If you've been managing the process effectively and have kept your optionality, you should feel good about the decision to move forward to signing and closing.



# Preparing for life after the deal

Congratulations. You've sold your business and as of today, wealth that had been tied to the company is no longer illiquid. If you are like many sellers of privately held companies, you're now the owner of liquid assets of a once-in-a-lifetime scale.

What should you do now? Celebrate to be sure. But in short order, recognize that managing wealth well is not too dissimilar to running a business successfully for many years. You have alternatives to preserve wealth for a long time and/or ensure it flows where you want it to in the most tax-efficient manner as possible. This is when business gets personal.

The final section of this report is about the alternatives related to planning your financial future and managing wealth. As we've discussed throughout, early planning and preparation goes a long way with a very financially significant event like the sale of a business. This includes tax planning. While value is hopefully at a maximum at the time of the sale, transfer costs are also higher. Decisions made about the structure of the transaction will factor now, as you plan your financial future outside of the company.

Minimizing ordinary income tax treatment in favor of long-term capital gain taxation is preferred due to the significant rate differential of a top rate of 37% for ordinary income as compared to 20% for long-term capital gain. Due to the complexities surrounding the new tax law and of income tax in general, it is essential that the private business owner engage with seasoned tax advisers to ensure the best possible tax outcome.

You will also want to weigh wealth transfer planning alternatives. There are different types of trusts designed to ensure tax-efficient transfers of wealth; in addition, family foundations, insurance options and retirement investment strategies are among the decisions ahead.

## Managing your wealth like you've managed your business

Former private company owners need tax-efficient means for preserving their hard-earned wealth and transferring it to successive generations. An appropriate plan blends personal, financial and tax considerations into a comprehensive family wealth transfer strategy or business succession plan to preserve a family's wealth. An effective plan will meet your objectives, whether those objectives are to maximize the benefits of ownership and assets; distribute assets to family members or charities; appoint capable estate managers as executors and trustees; minimize taxes, probate and administrative costs; and/or ensure the liquidity and stability of your estate.

Key considerations include: The role of an advisory team, components of an investment plan and diversification strategies.

### Assembling the right advisory team

Changes in the rules with respect to income, estate, gift and generation-skipping taxes have made planning increasingly difficult. A total wealth management approach to financial planning, using appropriate advisers, ensures that all the elements of your wealth management plan will be coordinated and that you'll receive comprehensive advice that allows you to focus on your personal aspirations instead of worrying about your financial security. An adviser-managed systematic approach can help individuals and their families to coordinate planning among:

- Tax compliance
- Tax consulting
- Investment advising
- Wealth transfer strategies (estate, gift and trust planning)
- Human resource services
- Family business succession planning
- Insurance risk management
- Administrative services
- Charitable planning and administration
- Education funding
- Retirement planning
- Beneficiary designation planning

### Should you take the step to form a family office?

For many high net worth families, wealth management has become multigenerational, which has created a strong demand for tax, estate and philanthropic services, among others. Some families look to create so called "hundred-year plans" whereby family members are treated as business divisions and emphasis is placed on corporate-inspired guidelines such as family mission statements, governance structures and guidelines for communication.

High-net-worth individuals will pass along wealth someday just as they pass down values now. Managing wealth can be particularly complex as policies and tax laws change. Employing financial, legal, and tax professionals can help, but families must be vigilant in understanding and evaluating their work.

In addition, dealing with the day-to-day affairs of the management of family wealth is time intensive. Coordinating various advisers monitoring investments and conducting daily financial activities can be daunting tasks. Also, family stakeholders may not be able to evaluate objectively the services performed or be aware of what is available to them. Establishing a family office to manage a family's business, family entities, investments and/or personal activities may thus help ease the burden of managing wealth effectively.

A family office offers a unique way for a family to manage its wealth, maintain family continuity and advance the family agenda. In the context of a family office, professional advisers can help individuals identify and evaluate their current and future wealth management objectives, increase tax efficiencies, reduce administrative costs and further advance the family agenda.

### **Income tax planning**

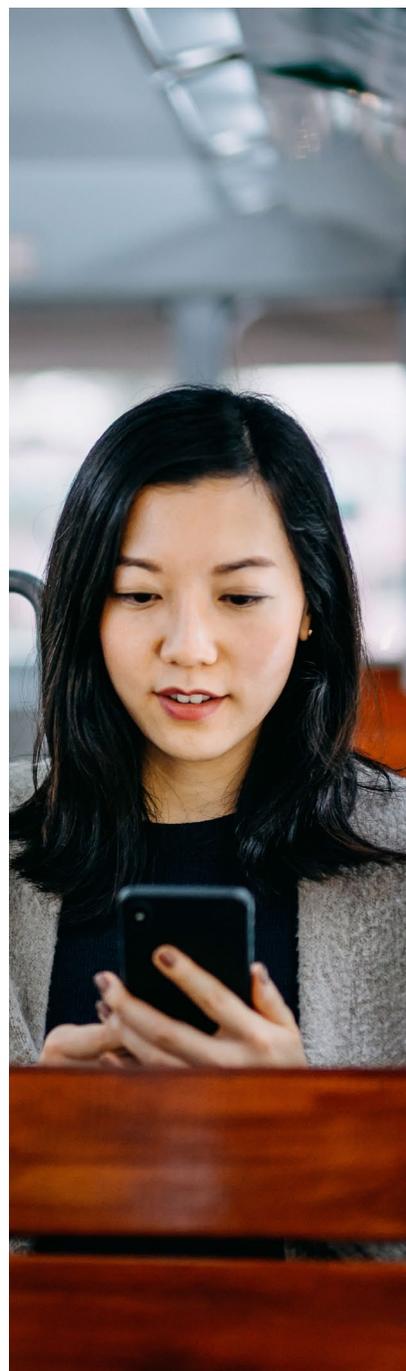
Income tax planning focuses on strategies to quantify and reduce current and future year federal, state and local income tax liabilities and can help you reach your personal goals. Here are a few examples:

- Determining the timing and structure of charitable gifts to increase the value of the income tax deduction
- Evaluating investment transactions to determine a tax strategy for capital gain/loss recognition
- Revising debt structure to increase the portion of interest expense eligible for current income tax deductions

### **Developing a strategic investment plan**

An effective strategic investment plan will incorporate tax planning and risk management alongside investment strategy and implementation. This plan must be tailored to an individual's financial goals and risk tolerance and then monitored on an ongoing basis to make sure it is being properly implemented and goals are being met. Considerations involved in managing a strategic investment plan include:

- An understanding of the tax consequences associated with investment products recommended by the investor's money manager(s) or based on tax attributes of the particular portfolio (e.g., private foundation, charitable trust, personal portfolio, trust for the benefit of children)
- Selection and retention of money management firms
- Investment performance reporting on both fund and portfolio bases
- An investment policy that balances long-term needs and risk tolerance
- Implementation of an appropriate asset allocation strategy
- Selection of fund and account managers who are focused on after tax results and, in some cases, on obtaining reduced investment minimums and management fees
- Ongoing portfolio performance and related adjustments in the investment policy



## The importance of diversification and asset allocation

Diversification is at the very root of investment planning. One might think that diversification is accomplished simply by engaging multiple investment advisers, opening multiple accounts or investing with a variety of mutual fund companies; but it actually involves much more than that. Effective diversification deals more directly with proper asset allocation and the division of the allocation into sizes, styles and sectors of the market.

Research has proven that over 90% of a portfolio's return performance is credited to its asset allocation, thereby dramatically overshadowing other components, such as security selection, adviser selection and market conditions. As a result, it is extremely important that careful consideration be given to diversification of an investment portfolio appropriately at the onset of the development of an investment strategy. Likewise, review and follow up are important to ensuring that investments stay on track.

The goal of asset allocation is to make varied investments that move independently in the market and create a diversified investment base. This diversification can be tailored according to one's time horizon, risk tolerance, need for liquidity, marketability and capital appreciation. Asset allocation and diversification can help protect against the volatility of the marketplace because various sectors of the market will outperform or underperform at different times. However, it is important to note that diversification will not eliminate risk. Market risk, otherwise known as systemic risk, will always be present when you are investing in the market.



## Family issues—yours, mine and ours

### The tools of effective wealth preservation and transfer

As you exit your business, one of the most profound effects of newly liquid wealth is likely to be on family dynamics. A wide range of decisions will be required with respect to lifestyle, to how much wealth to give to children and others, to what form those gifts should take, and to the timing of those gifts. You will also want to consider transparency issues within the family: who should know what, and when it should be known.

As a result, family goals and needs should play major roles in most, if not all, of your wealth management and transfer decisions and actions. Your planning may need to manage, and balance, the dynamics of marriages, children, grandchildren, stepchildren, in-laws and others.

### Wealth transfer planning

The primary purpose of estate planning is to ensure that you, not the state, direct how your assets get distributed. Another goal of estate planning is to eliminate or minimize federal and state income and transfer taxes.

Proper wealth transfer planning is an integral part of successful wealth management. Done correctly, wealth transfer planning ensures that assets pass to family members, charities and other intended beneficiaries at the lowest transfer tax cost possible while retaining as much control as desired. Overlooked, wealth transfer can tear a family apart, turn children against one another, lead to forced sales and ultimately leave inheritances lost to taxation and legal fees.

## Estate planning

For estate tax purposes, most individuals can view their future estate as consisting of three baskets. The first is the applicable exclusion amount, or the amount that each person can pass free of gift/estate tax to others. This exclusion allows you and your spouse to minimize the tax on property that eventually passes to your heirs. The second basket is the unlimited marital deduction, which lets you pass all of your assets to your spouse (assuming he or she is a US citizen) without paying estate tax. With proper planning, the third basket, life insurance proceeds, can be removed from both your estate and that of your spouse.

Additional techniques allow for further reductions in estate taxes. Charitable giving, which can create a fourth basket, can be accomplished either outright or through a stylized trust. Lifetime gifts to children and grandchildren can pay for educational expenses, launch a business or buy a home as well as reduce your prospective estate. Trusts can be used for an almost unlimited number of purposes. There are many ways to implement effective estate planning. What follow are descriptions of some of the major estate planning essentials and tools to consider.



## The will: the foundation of your estate plan

The will, a legal document created by an individual to provide instructions for survivors following the individual's death, is the most basic and essential estate planning document, yet many people either have no will or have one that is very much out of date.

One of the most important things a will does is avoid intestacy, which is the situation when an individual dies without a valid will. There is an old but true adage: "If you don't make a will, the state where you live will make one for you." Each state has intestacy laws that determine who gets our property and how much of it. In many states, these laws are based on social benefits that were held perhaps a hundred or more years ago. For example, your property generally would be split between your spouse and children, and just how much your spouse might receive could depend on the number of children you have.

Wills accomplish many goals, such as:

- Directing assets to persons you designate
- Tax planning and tax savings
- Naming executor(s) and trustee(s)
- Appointing guardian(s) if needed
- Establishing trusts to take effect at death, including:
  - Marital trusts to minimize estate tax for married couples
  - Trusts that delay receipt of an inheritance by minor children
  - Special needs trusts that make funds available for disabled adults

A will cannot distribute non-probate assets (e.g., IRAs and life insurance), avoid probate or change the statutory rights of a surviving spouse.

### **A revocable living trust (RLT) can serve as a valuable supplement to a simple will**

A revocable living trust (RLT) can serve as a valuable supplement to a simple will. In an RLT, a grantor contributes assets to the trust while retaining the right to revoke the trust or reclaim ownership of trust property outright during life. Trust assets are not subject to probate. An RLT accomplishes the following:

- Establishes an individual's estate plan and directs assets at death, similar to a will
- Ensures the privacy of the decedent's estate and of the surviving family members
- Avoids the administrative fees associated with probate
- Avoids probate in each state in which property is owned (advisable if the grantor owns property out of their home state)
- Is a way to manage property for minors or incapacitated adults
- Facilitates funding of other trusts

## Life insurance coverage and estate planning

Life insurance is a contract between an insurance company and the insured. In the contract, the insurance company agrees to pay a stated amount of money to a beneficiary upon the death of the insured in exchange for a sum of money, known as a premium, paid by the policyholder. The primary functions of life insurance are to pay off debts, to cover expenses created by the death itself (e.g., estate taxes) and to provide financial security for the family of the deceased.

A reasonable approach to determination of life insurance needs is to examine three specific areas:

- Capital resources (the funds available upon your death)
- Capital needs (the cash needs at your death)
- Survivor income needs (the cash your survivors will need during their lifetimes)

How you own life insurance is important. For the proceeds to be excluded from your estate for estate tax purposes, you should not own the policy personally. For more information, see the later discussion of the irrevocable life insurance trust.

## Gift tax planning

Determining a gifting strategy may be one of the greatest challenges of newfound liquid wealth. You will need to consider such questions as: What is fair versus what is equal? What is too much? What is too young? What is the right timing with respect to both tax and nontax factors? When should I consider trusts to deal with beneficiaries' age or maturity or other factors? What will your needs be should you live beyond your life expectancy?

## Annual exclusion gifts

One of the most powerful and often underestimated tools for transferring wealth is the use of annual exclusion gifts. Each person is allowed to make individual gifts of up to \$15,000 (maximum annual exclusion gift amount in 2019) per gift to as many people as desired without incurring any gift tax. Therefore, a married couple are permitted to give up to \$30,000 to each of their children, grandchildren or others without paying gift tax or reducing their applicable exclusion amount. Such gifts can be made to anyone regardless of relationship. Gifts made to spouses are not subject to gift tax. It should also be noted that gifts made for medical and educational expenses are not subject to gift tax if made directly to the provider or institution.





## Trusts

Trusts have long been considered the cornerstone of effective estate plans. Whether established during lifetime or at death, trusts can provide significant tax and nontax benefits for the trust grantor (the trust's creator), as well as for such trust's beneficiaries. Carefully designed and managed trusts can provide for and protect your family members or others while allowing you to set initial parameters regarding the management of those assets.

A trust is a legal arrangement whereby an individual (the grantor) transfers property, along with instructions (in the form of a trust document) to a trustee (a trustworthy representative, either an individual or a corporation such as a bank trust company) to manage and distribute to the trust beneficiaries as outlined in the trust document. Property held in the trust will be distributed according to the terms of the trust. Trusts can be used for a variety of purposes, including in assisting in the management and distribution of assets and in minimizing taxes. Here are some of the more common trusts used in wealth management and transfer:

### **Irrevocable life insurance trust (ILIT)**

An ILIT is a vehicle that enables surviving family members to utilize life insurance proceeds to replace current income, to provide liquidity to pay estate taxes and/or to meet special estate planning goals (e.g., equalizing value to children, benefiting children from different marriages). The irrevocable trust acquires a life insurance policy on the grantor or a second to die policy on the lives of a married couple. The death proceeds received by the trust will be excluded from the estate of the grantor if the grantor is free from any incidences of ownership or control over the trust. Proceeds will be excluded from estate tax inclusion from a policy that is purchased by the trust, while there is a three-year inclusion period on proceeds that are received from the transfer of an existing policy to an ILIT.

### **Grantor retained annuity trust (GRAT)**

A GRAT is a trust for transferring assets with ideally high appreciation potential to beneficiaries at a significantly reduced transfer tax cost. The grantor transfers the property into a trust while retaining an annuity stream for a stated period of years. At the expiration of the term, the property remaining in the trust is transferred to the beneficiaries. The transfer of assets to the GRAT creates a taxable gift equal to the fair market value of the assets at the date of gift minus the actuarially determined present value of the retained annuity stream.

Because the annuity is typically set such that the retained interest is essentially equal to the fair market value of the assets transferred, the gift is de minimis. At the end of the GRAT term, the remainder interest that passes to heirs is completely out of the grantor's estate. Because the present value of the remainder interest is calculated based on the interest rate at the time the trust is established, GRATs can be especially effective during periods of low interest rates. As of this writing, we are in one of the historically lowest interest rate environments for this type of trust planning.

### **Intentionally defective irrevocable trust (IDIT)**

Use of an IDIT is a technique that may allow you to transfer the future appreciation in an asset to beneficiaries while keeping the current value of the asset, plus a fixed annual interest payment. Typically, there are two basic types of IDIT transactions: gifts and sales. For a gift transaction, the way the trust is drafted would cause any gifts to the trust to be treated as completed gifts for estate and gift tax purposes but not for income tax purposes. Alternatively, a sale transaction can be used to reduce the gift tax that might otherwise be due on a simple gift transaction.

After setting up an IDIT, you would sell an asset to the trust in exchange for a promissory note. The IDIT should be seeded (the gift component) before the sale with an equity amount (generally 10% of the sale amount) that would substantiate the trust's ability to make payments on the loan. The terms of the promissory note would require the trust to pay you an amount equal to the fair market value of the property at the time you sold the asset to the trust, plus a fixed rate of interest as set forth monthly by the IRS. Similar to GRATs, IDITs work best in a low interest rate environment. If the trust assets produce a rate of return that exceeds the specified interest rate, the IDITs beneficiaries will receive the excess either in trust or outright, at little to no gift tax cost.

Although the IDIT will be the legal owner of the asset, the grantor will remain liable for the tax on the income earned in the trust, hence the trust is "defective" meaning yours for income tax purposes but not for estate tax purposes. The reason an IDIT is nonetheless an appealing option is that the income tax payment provides an income and estate tax benefit for the trust beneficiaries. The tax benefit stems from the fact that what the beneficiaries ultimately receive from the trust will not be diminished by the income taxes generated by the trust, yet payment of the income tax by the grantor is not considered an additional gift to the trust or to the beneficiaries.



### **Dynasty trust**

A dynasty trust is generally created as part of a plan to mitigate the impact of the generation-skipping transfer tax (GST). This is an additional tax applied against the value of property that is transferred to individuals who are defined as skip persons. A skip person is someone who is two or more generations younger than the person who is making the transfer, such as grandchildren.

The GST tax is in addition to potential estate or gift taxes on the same transfer. It is designed to make sure that a tax is, in fact, collected on the transfer of wealth from one generation to the next. A dynasty trust helps you take full advantage of your GST tax exemption and is typically set up to last for as long as the state law governing the trust allows.

A dynasty trust may be established either during your lifetime or through your will. It allows you to set aside assets for your grandchildren and future descendants (while still allowing for distributions to your children, if necessary) without paying gift, estate or GST tax in each generation. These techniques are not always mutually exclusive so an IDIT could also be structured as a dynasty trust.

### **Qualified personal residence trust (QPRT)**

A personal residence, either a principal residence or a vacation home, can be transferred to the beneficiaries of a QPRT at a discount from the home's current fair market value. The grantor can continue to live in the home for a specified term of years and continue to take a mortgage interest deduction as well as a real estate tax deduction. After the term interest in the trust ends, the trustee may decide to rent the home to the grantor at a fair market rental value. The payment of rent is an excellent means to further reduce the estate. Unlike GRATs and IDITs, a higher interest rate environment for QPRTs is better for gift tax purposes.

## Charitable trusts

Trusts can help you to achieve your charitable objectives and obtain a charitable deduction while still retaining an interest in your property or giving an interest in the same property to other beneficiaries, such as children.

In a charitable remainder trust (CRT), you would transfer assets to the trust and either keep or give to others the right to receive an annual annuity or unitrust payment for a specified number of years or for life. At the end of the term of the CRT, the remaining assets pass to charity. The grantor receives a current charitable income tax deduction at the funding of the trust equal to the present value of the remainder interest actuarially calculated.

A charitable lead trust (CLT) essentially works in reverse. The charity is entitled to receive an annuity or unitrust amount for a specified number of years. At the end of the term, the remaining assets are returned to you or given to the non-charitable beneficiaries of your choosing.

Upon creation of the CLT, the donor is allowed a charitable deduction for income tax purposes provided that the donor agrees to be taxed on the trust's annual income as it is earned (Grantor CLT). If the donor chooses not to be taxed on the trust's income, no charitable deduction will be allowed nor will the donor be taxed on the trust's income (Nongrantor CLT). Instead, each year the CLT will file a tax return and be entitled to a charitable deduction generally equal to the value of the annuity paid to charity to use against the CLT's own income.

Important gift tax and estate planning objectives can be achieved through the use of a Nongrantor CLT. Typically, the transfer of property to a family member will result in a current gift for gift tax purposes or will trigger estate tax upon the grantor's death. However, the gift or estate tax is lower with a CLT because the value is reduced by the value of the income interest received by charity.



## Family limited partnership (FLP)

A family partnership is an excellent way to manage and grow wealth. The family partnership is a separate business entity that can hold title to assets, collect income and gains, pay expenses and file tax returns. A family partnership often takes the form of a limited liability company (LLC), which is treated as a partnership for tax purposes or a limited partnership, both of which are often referred to as a FLP.

One popular reason for forming a FLP is to facilitate the transfer of wealth. That's because making gifts of partnership units to children or grandchildren, or setting up trusts for their benefit, allows the passage of family wealth without losing any of the sophisticated investment attributes available to large investment pools. Generally, property is contributed into a FLP in exchange for both general and limited partnership units. As a rule, the retained value of a general partnership interest will be small because the objective is to transfer the bulk of the value (through the limited partnership units) to younger generations. If the partnership is properly structured and administered, gifts of partnership interests will not be included in the donor's estate once those gifts are complete.

Additionally, there is a level of asset protection associated with family partnerships. The partnership unit ownership can be restricted to family membership or to trusts for family members. In addition, such partnerships offer protection of assets from creditors. Finally, they enable family members to invest through a single vehicle, which can reduce investment costs, facilitate recordkeeping and provide flexibility that might not be available in a trust arrangement.

Extra care should be taken when establishing family partnerships, as the IRS challenges family partnerships that are not respectful of partnership tax laws. Additionally, the gifting of limited partnership interests to family members often results in discounts for gift tax purposes for both minority interest and lack of marketability concepts. The IRS frequently challenges such discounts so proper attention to valuation concepts through the hiring of a reputable appraisal firm is likewise important.



## Private foundations and donor-advised funds

Private foundations are tax exempt charitable organizations, typically created by families to effectively direct charitable contributions. They can be distinguished from public charities in that they generally do not receive contributions from a wide range of supporters. Although private foundations are not without disadvantages, they do offer the following benefits:

- The charitable and philanthropic objectives of the donor may be carried out in perpetuity
- The donor may claim a charitable deduction for the year the contribution is made and make actual distributions to charities from the foundation in later years
- The donor and the donor's heirs can control the administration and investment of assets of the foundation, as well as distribution of funds
- The donor may address specific charitable objectives that may not be addressed by other organizations
- Heirs can be trained to manage wealth and become philanthropic through distribution activities
- Family members can be paid a salary that is reasonable for the services performed
- Foreign charities can be grant recipients of the foundation where individuals generally cannot make charitable contributions to foreign charitable organizations

Alternatives to private foundations include:

- **Community foundations**

A community foundation is a fund designed to attract assets for the benefit of a particular geographic area. Community foundations are treated as public charities (not as private foundations), so the donor has a large degree of flexibility both in structuring the gift and in advising the foundation on how to benefit the surrounding community.

- **Donor-advised funds**

Donor-advised funds provide another way of retaining a degree of control over contributions. Like community foundations, donor-advised funds are public charities. Most financial institutions offer donor-advised funds which allow the donor to make suggestions to the fund for future charitable grants. The donor receives an income tax charitable deduction upon funding of the donor-advised fund.

# Welcome to the rest of your life

You've successfully navigated the exit from your business. Your vision for your family's future, and its financial security, is uniquely your own. We trust that the thoughts in this publication will help you begin to navigate that future.



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Thank you!