John Brown:

So we need to look at the total tax consequences in a family-run transfer, which we don't have to do as advisors if we're transferring the business to the family.

Elizabeth Mower:

Hello, this is Elizabeth Mower president of BEI.

John Brown:

And I'm John Brown, the founder of BEI.

Elizabeth Mower:

Each episode we take you into the world of exit planning, sharing the stories, struggles, and opportunities of business owners and their advisors. We'll get into this episode's conversation right after this.

Jared Johnson:

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Elizabeth Mower:

Today, we have an interesting topic to discuss. I was recently speaking to an advisor who just wanted to talk over some ideas and bounce things around for a client who had approached the advisor, they've worked together for a long time, and this client is an owner of a business and has a child who's been working in the business for quite some time and has been doing really well according to this business owner, has a couple of children who don't work in the business and are not interested, all of whom are adults, so all the kids are adults. And the business owner came in and said, "Can you please help me come up with a way to sell the company to my business active child?" I think it was a daughter in this case, "So I'd like to sell the business to my daughter within the next few years. I'm looking towards retirement. She's been doing a really good job of building her leadership and helping me run the company and I think I'm ready to do it. I'm ready to sell".

Elizabeth Mower:

And the first thing I said to this advisor was, "Okay, tell me more about what is motivating this business owner to say that he wants to sell the business to the daughter?" He didn't say transfer, transition, hand over the baton or anything like that. It was a definite "I need to sell. Can you help me structure a sale so that I can get that done within a certain period of time?" And John, you've seen this before, the business owners are pretty focused on the idea of a sale to a child. So let's just get out of the way, what are the red flags that that first come into our mind, which we're not necessarily going to say to our clients because it might sound like resisting their plan to sell, but the red flags that go up when we hear sell to a child.

John Brown:

Well, the tax red flag is that it's the most expensive way to transfer ownership to a child from a tax standpoint. Why is that? Because the child has no money of their own. So if they're going to buy the business from mom and dad, they have to first get money from the company, which is in terms of salary or nest distribution, it will be a tax consequence there at the child's maximum tax rate that they're paying. That money isn't going to be paid to the parent owner who's going to pay a second tax on it.

Elizabeth Mower:

Ouch.

John Brown:

Ouch, yeah. So the tax rate, combined tax rate, generally speaking on the taxable income that comes from the company, ends up being around 50% sometimes more. So that's not necessary to do.

Elizabeth Mower:

Right. Okay. So we've got some tax issues that come up. You slid another one in there, which is that this "buyer" doesn't have any money. So no financial wherewithal and no resources. We're going to have to be completely dependent on the company, which this business owner already owns and gets the benefit of. So one of the questions is, are they really even selling when they go to try and have a child buy the company?

Elizabeth Mower:

So then let's switch gears a little bit, talk about the nontechnical or the non sort of tax aspects of selling a business to a child. What are the intangible or emotional reasons why a business owner might want to sell the business to a child rather than, "I'm just going to give it to them. They're just going to own it. I don't know, I'll just leave it to them in my will" or whatever. So there's obviously something going on here that's making the business owner think that a sale is important. And so give us some examples and I'll share some to maybe of why we're having that conversation with our clients.

John Brown:

So in my experience, and again through our members in our practices, we've dealt with hundreds and hundreds of these family transition scenarios, probably the number one reason why the owner is thinking of selling the business to a child is because they're not aware of alternatives. They just don't know. And I've given lots of talks to business owners about alternative forms of transferring ownership and usually that are more tax sensitive and still get what the owner wants and needs and gets the rest of the family what they want and need, and the owner's just totally unaware. They'd never spoken to anybody about it. And sometimes they'll come up to me after a talk and say, "John, I just sold my business to my daughter using an installment note. How do I get out of that?" And there's not a way to get out of it really that's not going to create some significant tax consequences.

John Brown:

So a lot of it is really based on lack of knowledge. Owners know they can give the business away, but all of us here listening in probably have business owner clients who believe that the annual gift tax exclusion is $3,000 a year. They just don't know. And it's because they're business owners and they're working in their business.

Elizabeth Mower:

And they're really good. They're not really good at ownership transition.

John Brown:

Right, and their advisors have done nothing. They haven't reached out, which is true about 80% of the time. No advisor's ever spoken to an owner about their plans for leaving the business someday or transferring ownership so they just don't know.

John Brown:

So for us listening and the first thing to do is to just ask some general questions. What's the knowledge base? What's the goals of the owner, the owner's spouse, their combined goals in terms of transferring money? How much money does the owner need? So the way I always address this, Elizabeth, we're in a family transition scenario, is I backup to understanding what the owner and the owner's spouse want and need out of the business, because that's then going to set the minimum amount of money net after all taxes that we have to get to the senior generation. And then we can look at how the junior generation, whether it's one child or a bunch of kids who are going to acquire ownership, what's the most tax efficient way of getting that amount of money to the parents while transferring ownership?

Elizabeth Mower:

Right. And I can maybe add to that, that's one of the things that I would say is driving these requests from clients to sell their business to their child is that there is some amount of money that the owner believes that they need.

John Brown:

Right. Yeah.

Elizabeth Mower:

And they think, "Well, I guess I'll get it from selling".

John Brown:

Yeah. And "If I sell it, I'm going to just going to pay a capital gains tax, so that's probably the most efficient tax to pay in terms of the lowest amount", which could be true. However, there's that second tax and greater tax that has to be paid when the child gets the money from the business and pays a tax on that. So we need look at the total tax consequences in a family run transfer, which we don't have to do as advisors if we're transferring the business to the family.

Elizabeth Mower:

I think I can jump in there and say that you're bringing up one of the points that I would have that I would have mentioned, which is that business owners believe in many cases that they still need some more money in order to achieve independence. And so the logical sort of way of getting that would be to sell the business. "I'd like for my child, my daughter here to take over, so I guess I'll sell it to her and she can figure out how to get the money and then I'll have enough money to sort of achieve my retirement goals. And in so doing, the business ends up in the hands of my child, I end up with financial independence. Isn't that great?" You can achieve those things with many other transition methodologies. But I agree with you, circling back, even though one of the reasons that a business owner might propose a sale is that they need money, your first point was they're just not aware that there are other ways to get resources for retirement.

Elizabeth Mower:

And I might also throw in another thing that I have seen many, many times is that the sale, the idea of the sale particularly, that way of transitioning ownership can be in many cases driven by the fact that this business owner may have other children or that the spouse of the business owner feels that a purchase would be more fair. And we've talked many times about the value of the business being the single largest asset that many business owners own. And if that's the case, maybe the business is worth $5 million or $10 million, and outside of the business the owner and spouse have maybe not accumulated a lot of wealth, but there are four children. And so the one who takes over the business, having a $10 million asset is the way the rest of the family might think about it. And then there's $1 million in retirement funds and another half a million dollars in life insurance, so there's a $10 million business and one or $2 million in other things. "So I must have to sell the business to this child because I can't give them something that's worth 80 or 90% of my total net worth". That happens quite frequently.

John Brown:

So it's important to separate the tax planning, the income tax planning on ownership transfers, from the family wealth transition planning, which can be very different and may not be driven by income tax planning. So it's a whole different set of issues. You can accomplish all of the family wealth planning, transfer considerations without selling the business. And that requires a lot more analysis than that we're going to be able to do in this podcast, but I want to suggest to the advisors listening in and the owners that selling the business really benefits the IRS more than it's going to benefit your other children, or the business active children, or you the parents of the business. So we need to think of other ways to transfer ownership. And there are other ways. There are many other ways of doing that. So that's one set of issues, the whole tax side of things that we need to pay attention to obviously, but they should not drive the transfer planning of a closely held business.

John Brown:

And I just want to mention one more thing at least for this podcast is that if we're selling the business to a third party, so Elizabeth is a third party buyer, I own my business, she offers me $10 million forward and I'm just going to pay a capital gains tax. That's great.

Elizabeth Mower:

Absolutely.

John Brown:

It's great for me because that probably is one of the lowest ways of paying net taxes is through paying a capital gains taxes. And I don't care how Elizabeth, the outside third party buyer, got the $10 million.

Elizabeth Mower:

Because I probably got it from some other source and then I'm going to look for a return on my investment from your business, but I'm not going to expect the business to literally pay you. It's going to pay me and maybe my lender back. But you don't care cause you're playing golf or traveling and so you're spending six months in Italy, and it doesn't make any difference to you where I got the money or what I have to do to pay it back.

John Brown:

Right. So I mean, if we look at it long-term, at some point, let Elizabeth has another company, or now this company, she's going to have to earn, or the company's going to have to earn 15, or 16, or $17 million to end up with $10 million to pay me for my 10 millions and I pay a capital gains tax. But I don't care that costs her 16 or $17 million. I just want her $10 million. In a family run business, I have to be concerned about also how she's going to earn the money to pay me.

Elizabeth Mower:

Right. The way I talk to people about this, it's about sort of drawing circles. So to continue on with your point, which I totally agree with, is that when there is a third party coming in from the outside, that's why we call them an outside buyer, we're going to draw a circle around the owner or maybe the owner and his or her family, and we're going to do planning that creates the best outcome for those people. So some people will do some estate planning or some transfers before they put the business on the market, try to push wealth out to their kids or their grandkids. Those kinds of things. They might also do some tax planning, maybe try to improve the performance of the company or the companies-

John Brown:

There's some charitable planning to reuse the actual taxes, yeah there's a lot of things to do.

Elizabeth Mower:

So all of those that's the circle I want to draw if we're going in the direction of a third party sale. It's probably around the business owner, his or her family and their interests. But I agree, in a closely held business that's planning on remaining closely held, the circle you draw, not all advisors know this ... I'm still getting stories about non planning oriented advisers who have not yet adjusted their perspective. But we in planning, draw the circle around the business, the owner and the successor, not necessarily a family member who's a successor. It might be an employee or a group of employees or a management team. Also, people who tend not to have outside resources, who are going to rely on the business to make the transitions financially successful. And so now we're going to draw a circle around the company, the owner, maybe the owner's family, if that's important, and the next owner, whether it's a family member or what we would call an insider, co-owner, employee, et cetera. Draw a circle around all of them and then try to minimize the taxes and maximize the use of available dollars through our planning inside of that circle.

Elizabeth Mower:

And when we do these kinds of circles, people realize, "Oh, okay, well I have to sort of add up all of these players and the consequences for all of them, because if you and I are family members and we're transitioning ownership, what affects you also affects me". So that's the way we draw it out when we whiteboard these scenarios for clients or for other advisors, and it seems to help. And the tools that we use to run in different scenarios or model different transition plans will do the same thing. They tend to take the broadest possible look.

John Brown:

And I would say we do spend a lot of time and a lot of effort in this exact area, and the result is for business owners, about two thirds of the exit plan implementations, our members really do for business owners are transfers to insiders. They're not third party sales. And I think that demographic or statistic is very different in the world at large, outside of the planning that we do, because most owners don't have the benefit of the type of tax planning and family planning that our members do. We focus on this every single day. Third-party sale is a lot easier for business owners to do, frankly. They develop a business worth a lot of money, they sell it, they pay capital gains-

Elizabeth Mower:

It's a little more straightforward.

John Brown:

It can be very straight forward. Not always, but can be pretty straight forward. Family planning takes more analysis and thoughtfulness, but the result can be and is exactly what the owners want. And that is why we plan.

Elizabeth Mower:

That is why we plan. So when we get these questions, I get it from an advisor, an advisor gets the question from a business owner, or if there's a business owner listening here and they had this idea in their head that they were going to go ahead and sell a business to their child, then I think what we're really saying is, have a bigger conversation about why a sale seems important, what a client or a business owner is hoping to achieve through a sale. What are the outcomes? What are the things that that gets you? "It gets me peace in the family". "Okay, if I could get you peace in the family in another way that's more efficient, would you be interested in talking about it?" "Yes, I would". So, what are we trying to achieve through a sale to a business active child and can that be achieved in another way through planning that actually creates some additional benefits?

Elizabeth Mower:

And certainly owners are welcome to sell their businesses to their children, but I think when they are confronted with the possibility of getting other outcomes that might be better and still achieving the same things that the sale would have achieved, most owners will go with a planned transition rather than, can we get some documents and do a sale to my daughter by the end of the year?

John Brown:

Right.

Elizabeth Mower:

That's why we plan. So those are the takeaways for today. And if you're an owner listing, we encourage you to have a conversation with an advisor who can draw a circle that's bigger than just you, somebody who can really look at all the different moving parts and help you manipulate them to get a better outcome. And if you're an advisor, then we encourage you to do that backup when you're having these conversations with business owners to see, is there something else that could be done that would improve the outcome for everybody? All right, that's why we plan.

Elizabeth Mower:

Thank you very much, John, for being here. I appreciate it.

John Brown:

And thank you for listening in.

Elizabeth Mower:

We'll see you next time.

Elizabeth Mower:

Thanks for listening. Join us for our next episode. For more content like this, please visit exitplanning.com.