Transferring a Business to Insiders

Selling your business is an important financial transaction that requires a well-developed exit strategy.

Many owners view their business as much more than an asset. They've poured their hearts and souls into it. Maintaining the established business culture motivates them to sell to insiders. According to the Business Enterprise Institute, Inc., nearly 95% of all sale transactions involve insiders, who may include co-owners, family members, managers and key employees. The insider group that is buying the business is called a key employee group (KEG).

There are four ways to transfer a business to insiders:

1. LONG-TERM INSTALLMENT SALE. The owner holds a promissory note, signed by the KEG, with installment payments over seven to 10 years. The note is secured by the assets and stock of the business and the buyers' personal collateral, such as a second mortgage or bank loan. Little or no money changes hands at closing. If the KEG does not maintain the company's profitability; however, the owner might not receive the purchase price.

2. LEVERAGED MANAGEMENT BUYOUT. A leveraged buyout is an attempt to purchase the business with borrowed money. This arrangement is ideal when the KEG can operate the business without the owner's input and the company has a stable cash flow and a solid, tangible asset base. This method rewards key employees and positions the company for growth, while minimizing or eliminating ongoing risk.

3. EMPLOYEE STOCK OPTION PLAN (ESOP). An ESOP is a tax-qualified program that must invest primarily in the company's stock. The company's contributions to the ESOP are tax deductible and tax free to the ESOP. In an ESOP arrangement, the owner is largely cashed out of the business, and perhaps carries only a portion of the purchase price of the stock sold to the KEG.

4. MODIFIED BUYOUT. Most owners prefer a modified buyout. An owner makes a pool of non-voting stock (about 40% of total ownership) available for current and future purchases by the KEG.

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Employees purchase stock via a stock purchase agreement. After the employees pay for the stock (usually 3 or 4 years), the owner can decide to:

• Sell the balance of the company to key employees at fair market value for cash

• Sell to an outside third party

• Continue to own the company.

The advantages of a modified buyout are:

• Acquiring part of the company at a reduced cost rewards and motivates employees.

• Trusted and knowledgeable key employees will receive the entire business.

• Owner receives the company's fair market value.

In a modified buyout, the owner does not receive the entire purchase price for three to four years, and usually remains active in the business until the initial employee buy in is complete. The modified buy out is a win-win situation for the buyer and seller because the low initial value allows a buy out with future cash flow, reduces taxes, provides an incentive and sets up a low price for the eventual cash buyout.

Whatever method the seller chooses, the objectives are to maximize the income from the sale and minimize the value of the business to reduce the seller's capital gains taxes on the sale. It also is critical to provide an "out" so if payments cease, the business can be sold to an outside party.

Leaving behind a self-sustaining company is the epitome of stewardship. When the transfer is final, sellers must accept that the new owners will run the business their own way. The seller may feel sad and should develop outside interests - whether personal or professional - to keep occupied. The sale marks a new beginning for the seller and the buyers of the business.

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GE-117038 (1/17) (Exp. 1/20)