Stratus WEALTH ADVISORS

COMPARISON OF OWNERSHIP TRANSITION OPTIONS FOR INDEPENDENT BUSINESS OWNERS

Transition Option	Market Value at Sale	Retirement Cash Flow	Tax Factors	Estate Planning	Preservation of Legacy and Culture	Employee Retention
Internal Transfer (Family Member)	Typically lower than external sales due to the desire of both buyer and seller to see the business succeed. However, strategies to increase value can be implemented because these strategies should increase cash flow as well.	Sales can be structured with a seller's note or deferred compensation to spread payments over multiple years. This can also ease the cash flow crunch on the incoming owner.	These sales are typically stock sales and in most instances will qualify for long-term capital gains treatment. Owners who will not need 100% of the purchase price to fund their retirement can gift a portion of the business to their children.	It is important that all family members, both current owners and future owners, update their estate documents. If a transfer will involve multiple owners, a buy-sell agreement or operating agreement needs to be drafted or updated.	By starting early, the current owner(s) have the opportunity to teach the next generation the values that define the business.	By starting early, the current owner(s) can work with the next generation so they can learn the business and gain the respect of employees at all levels.
Internal Transfer (Key Employee)	Typically lower than external sales due to the desire of both buyer and seller to see the business succeed. However, strategies to increase value can be implemented because these strategies should increase cash flow as well.	Sales can be structured with a seller's note or deferred compensation to spread payments over multiple years. This can also ease the cash flow crunch on the incoming owner.	These sales are typically stock sales and in most instances will qualify for long-term capital gains treatment. Owners who will not need 100% of the purchase price to fund their retirement can use a Section 83(b) election to grant a portion of the business to a non-family employee.	It is important that everyone involved in the transfer updates their estate documents. If a transfer will involve multiple owners, a buy-sell agreement or operating agreement needs to be drafted or updated.	Key employees have typically worked for a long time and therefore have a solid understanding of company culture. However, the current owner(s) should continue to discuss culture and legacy with the incoming owner(s).	Current employees will likely be familiar with key employees and this will be helpful for retention. Further, key employees are unlikely to drastically cut jobs because they understand the value of the business to the local community.
External Transfer (Competitor)	Typically higher than internal transfers if the business is a good strategic fit for the buyer and the buyer will not have to make large investments in the operations, processes, and/or people.	Most sales are structured with an earnout or seller's note to incentivize the outgoing owner to help make the transition successful. Earnouts should be based on gross margin.	These sales are typically asset sales, which means a portion of the sale will be taxed as ordinary income and a portion will be taxed as long-term gains. It is important to have a good understanding of how purchase price allocation impacts tax liability.	The outgoing owner needs to make sure their estate documents are updated. Further, the selling documents need to be specific about how the family gets paid if the owner dies during an earnout or seller's note.	Owners need to be careful when completing their due diligence on a buyer. Competitors or holding companies should be committed to maintaining the culture and legacy of high performing businesses.	Similar to preserving legacy and culture, owners need to do their due diligence on a buyer to understand how they have treated employees during previous acquisitions.
External Transfer (Financial Buyer)	Typically higher than internal transfers if the business is a good strategic fit for the buyer's exit strategy. Financial buyers are typically an option during periods when your industry is outperforming other industries.	Earnouts are typical to help the buyer maintain the value of their investment and these earnouts should be based on gross margin.	These sales are typically asset sales, which means a portion of the sale will be taxed as ordinary income and a portion will be taxed as long-term gains. It is important to have a good understanding of how purchase price allocation impacts tax liability.	The outgoing owner needs to make sure their estate documents are updated. Further, the selling documents need to be specific about how the family gets paid if the owner dies during an earnout or seller's note.	Owners need to be extra careful when completing their due diligence on a financial buyer. Most financial buyers are thinking about their own exit strategy and are happy to overlook culture and legacy for a higher return on investment.	Owners need to be extra careful when completing their due diligence on a financial buyer. Most financial buyers are thinking about their own exit strategy and are happy to reduce headcount for a higher return on investment.
Employee Stock Ownership Plan (ESOP)	ESOP values are competitive with the other transition strategies. Cash flow sustainability, payroll, and ongoing valuation and compliance costs are important variables to consider with this strategy.	ESOPs are quite flexible and can be structured to buy out the owner's shares over a period of time through tax-deductible contributions to the ESOP.	ESOP tax benefits for the seller begin when at least 30% of the business is sold to the ESOP. Tax benefits include potential lifetime deferral of capital gains for the seller and low to no federal income tax for the corporation.	Owners that use a 1042 rollover can defer capital gains indefinitely and potentially receive a step-up in basis upon their death. It is important that the proper documents are in place so these payments will continue even if the owner dies.	This is a great option for preserving the legacy of the owner and their family because the business is run by the people who know it the best - the employees.	Employee retention is typically high because the employees become owners and their purchase of company shares builds their retirement savings.
Worker-Owned Cooperative	Worker-Owned Cooperative values are competitive with the other transition strategies. Financing options and number of participating employees are important variables to consider with this strategy.	Similar to an ESOP, the buyout can be structured to allow a multi-year payout to provide an outgoing owner cash flow in the early years of retirement.	Cooperative tax benefits for the seller begin when at least 30% of the business is sold to the worker-owned cooperative. The profit that is paid as a patronage is tax deductible to the cooperative.	Owners that use a 1042 rollover can defer capital gains indefinitely and potentially receive a step-up in basis upon their death. It is important that the proper documents are in place so these payments will continue even if the owner dies.	This is a great option for preserving the legacy of the owner and their family because the business is run by the people who know it the best - the employees.	Employee retention is typically high because the employees become owners, improve their job security, build their retirement savings, and have a direct voice in how the business is operated.
Liquidate the Business	Typically the owner receives a discounted price for the inventory and furniture, fixtures, and equipment that is usable.	The owner is at the mercy of what the market will pay for their inventory and furniture, fixtures, and equipment.	One bright spot may be that the owner is able to take a loss on the assets they sell.	Owners who close and liquidate their business should still update their personal estate planning documents.	The business is closed so the legacy and culture of the firm will not continue.	The business is closed so employees will lose their jobs.

Notes and Sources: Information about ownership transition options is provided by Stratus Wealth Advisors. All owners should consider every available option, including an ESOP and Worker-Owned Cooperative, because no ownership transition is ever perfect and the more options we consider the better chance we have to create a successful transition for the three key stakeholders - the outgoing owner(s), the incoming owner(s), and the employees and customers.