Advantages of selling to employees

MERRICK WEALTH

By Peter Merrick

There are well over 100 tools, techniques, strategies, tactics and combinations thereof to enable high net worth individuals and successful business owners to manage their wealth in accord with their values and goals. Discovering the appropriate combination must begin with clarity about those values and goals.

Discussing specific strategies or tools is futile unless it is done in the context of exactly what the wealth holder sees as the end game.

The North American workforce is graying. Many successful business owners across this country say they are somewhat wary of selling their companies because of the unknown. It is very difficult for an owner to see their personal identity separated from their business.

That being said, the most important reason why owners want to sell their business is the prospect of creating financial independence for themselves and their families. They want to have the time to enjoy their lives, doing what they truly love without the financial constraints of having the vast majority of their net worth tied up a company.

The number one question that many successful business owners ask themselves and their advisors is "when is the right time to sell?" Before considering selling one's business your client needs to discover what his financial independence number is. This number is the amount of capital he will need to generate the desired return for the rest of his life. The number can turn a business owner into a business seller.

This number can only be understood by working with the client to help him develop a complete financial plan detailing everything he wants to accomplish in this lifetime and beyond. If it is determined that by selling his company today he could net out his magic number, your client is a prime candidate to sell his business.

If your client would not reach his magic number today by selling his business, he should consider developing new strategies to grow his business until the day the sale will generate his magic number.

The second question asked by business owners contemplating selling their businesses is "who should I sell my business to?"

Generally speaking, there are three categories of potential purchasers:

- Family members;
- Key managers or senior employees;
- A third party purchaser (which may be a strategic buyer such as a competitor or key customer or supplier, or a purely financial buyer such as a private equity fund, merchant bank or investor).
- Or, better yet, your client creates his own buyer who will buy at the best price. This is done via the vehicle known as an ESOP (Employee Stock Ownership Plan) or in Canada the Employee Share Ownership Plan.

When structuring the ESOP, any of the first three choices may end up being the effective owner of the business.

One interesting feature here is that your client doesn't have to go out and find a buyer and risk the loss of confidentiality about their plans to leave the business. They create their own buyer. This is known as a 100 per cent ESOP buyout. So how does this work?

In simple terms, your client creates a qualified retirement plan for their corporate employees known as the ESOP. Right now, your client owns the stock in his company. The company borrows the money from a financing institution to purchase the stock, loans it to the ESOP, which in turn purchases your client's stock from your client at a value established by an outside valuation firm (probably a higher value than a negotiated price with an outside buyer).

Now, your client does not own the stock, but he controls it by being in charge of the ESOP (as trustee).

It may be possible to defer the capital gains tax on the sale of shares until death, when your client will receive a step up in basis to ultimately avoid all capital gains taxes.

This is sort of a 'have your cake and eat it too' scenario where your client avoids capital gains taxes but gets the use of the money. Whether or not this is possible depends on circumstance, and it won't always work this way.

The company loan and the ESOP loan must be paid back. Over the next three to five years, the company funds the ESOP with tax deductible cash contributions on behalf of your client's employees, the contributions are used to repay the loan and shares are attributed to your client's employees. Your client continues to run the company profitably during the debt elimination time so the risk of someone else running your client's company and failing at it is eliminated.

You have now extracted the maximum value from the company and rewarded your client's loyal employees with an ownership stake in it. If your client has family in the business, he may arrange for them to have control of it going forward as trustees of the plan that owns all the shares.

Is the 100 per cent ESOP buyout right for your client? Maybe, but first you need to know your client's magic number, then you must have clarity regarding your client's goals. Together, the hard issue of the magic number and the soft issue of your client's goals will tell you if it is time to sell the business.

This article was co-written by Charles L. Stanley, wealth manager with Capital Financial Advisors in California.

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