

TRANSITION PLANNING: The Third Certainty for Closely Held Business Owners

When is it time to start thinking about the transition of your closely held business?

By Mike Ferraro





I once worked with a building materials dealer who always said he'd "get to transition planning someday." Someday came fast. A health issue forced decisions that should have been made over years, not months. The business made it through—but the stress and disruption were completely avoidable.

That experience reinforced something I've seen time and again: Every closely held business owner will face a transition. The only real question is whether it happens on your terms or someone else's.

I like to think of transition as the third certainty for closely held business owners. Just in case you forgot, the other two are death and taxes.

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This is the first article in a three-part series focused on transition planning for closely held business owners.

Over my 45 years in practice, I learned that one of the few constants in business is change. I also learned that the best way to deal with constant change is to plan for it—so you keep as much control as possible while the change is occurring. I consistently saw this approach used by the most successful companies I worked with.

Taking time out of your busy schedule to work on your business, rather than just in it, is one of the best investments you can make.

Every closely held business owner will experience multiple transitions during the life of their business. These may include upgrading facilities, opening new locations,

entering new markets, growing through acquisition, or transferring ownership to family, management, a strategic buyer, or private equity.

No two transition plans are the same. There is no single right or wrong way to execute a transition—only the best way for your unique situation.

The most successful transitions are addressed before an outside force dictates the timing. In other words, proactive transition planning almost always leads to better outcomes than reactive decision-making.

While transition can take many forms, there are two transition events that every closely held business owner will eventually face:

1. Achieving economic independence from their business
2. Transferring ownership of the business

Ownership transfer may involve the next generation, key management, a strategic buyer, or private equity. While family transfers and third-party sales share some similarities, they also present very different challenges.

A successful transition allows the business to continue with minimal disruption. It provides the owner with enough financial resources to live comfortably and leaves employees, vendors, and family reasonably satisfied with the outcome. Just as important, the owner is well-adjusted to life after the transition.

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Timing is everything. Knowing when the time is right requires planning and preparation. You shouldn't wake up one day and suddenly decide it's time to “do something” with your business. Whether you plan to transfer the business to the next generation or sell to a strategic buyer, the planning process should begin with an honest assessment of the owner's economic independence from the business.

To do that, several key questions must be answered.

What does the owner need to live comfortably?

This question has very different answers depending on the individual. It may include ongoing living expenses, one-time purchases such as a second home, healthcare planning, travel and leisure goals, family milestones like weddings and education, and support for aging parents.

Where will that money come from?

Will the owner need to retain a cash-flow stream from the business? Or will income come from personal savings, a liquidity event, retirement plans, personal investments, real estate, or some combination of these?

There are also important business questions that must be addressed.

How much capital should remain in the business?

This matters whether the business stays in the family or is sold. Excess working capital is often retained by the seller in a transaction, but retaining too much capital inside the business is not always beneficial.

What is the business worth?

Valuation depends on the buyer. A strategic buyer may be willing to pay more than what could be achieved in an internal or family transaction. This value should not be confused with what the owner needs financially. A back-of-the-envelope estimate often differs significantly from what a willing buyer will actually pay.

What are the income tax considerations?

Transition planning should include generational and estate planning considerations along with income tax planning at the entity and owner level.

Does the owner have a personal estate plan? Is there a taxable estate, and, if so, where will the cash come from to pay potential estate taxes? How much wealth does the owner want to leave to the next generation, and will the business be part of that transfer? If some children are involved in the business and others are not, asset equalization issues must also be addressed to ensure a fair and orderly outcome. Is the business entity in an unfavorable income tax position post sale? How much will the entity and owner income taxes be?

As you can see, there are many important questions that should be addressed well before a business transition occurs.

In the next article, we will focus on the specific challenges involved in transferring a family business to the next generation. The third and final article in this series will address transition planning when a family transfer is not a viable option. **LC**

Mike Ferraro is a director at Conifer Hill Advisors. He has more than 45 years of experience providing financial, tax, and management advisory services to companies in various industries. Mike sits on several boards and assists clients with establishing corporate governance, advisory boards, evaluating and growing enterprise value, and crafting exit strategies for business owners and their families. He can be reached at mferraro@coniferhilladvisors.com or 617-877-5800.