The Exit Strategies Newsletter

Exit Planning
The Tax Implications of an Internal Buyout

Business owners who are looking to their managers and employees to fund the buyout of their ownership in the business most often count on the ongoing, future cash flows of the business to make those payments. Unfortunately, these owners do not consider the two layers of taxation that these payments suffer, making the government one of the largest beneficiaries of this lack of exit planning.

Let's take a look at the mistakes that most owners in this situation make.

The first thoughts that most owners have towards their managers owning their business are consumed with whether or not the managers can run the business without them. The next level of concern addresses the negotiation over a price and terms by which the business will be purchased. In most cases, the vast majority of the money that you will receive for the sale will be paid in the future from the business cash flows. After all, if your employees and managers had the money to buy your business they probably would not be working for you. Now, assuming that all goes well, your managers will continue to run the business and generate enough cash flow to support the business and make the payments that are owed to you. So far, this all seems simple enough and if you have made it this far, you probably feel pretty good about the transaction overall.

But, let's take a moment to look at the additional weight that is placed on the business cash flows because no advanced planning was put in place.

<u>Two Layers of Tax</u>
The first thing to recognize about the business cash flow is that all payments to you, the [former] owner are made on an after-tax basis. In other words, the business cannot take a tax deduction for the payments made for the purchase of your stock. Therefore, each dollar that is paid to you is a dollar that was taxed at the

corporate rate. Let's look at an example to make this point:

In order for manager Phil to make a note payment to owner Jim for the amount due for the purchase of Jim's shares of stock by Phil, the business, Acme, needs to earn approximately $1.50 for every dollar paid to Jim. So, assuming that 1/3rd of every dollar is taxed at the corporate level (the actual corporate rate is 35% but we are rounding down to keep the math simple) we see that Phil and Acme need to generate $1.50 in profits to net $1.00 to pay to Phil.

A Second Layer of Tax

Now, once the payment is received by Jim, assuming that Jim sold his stock to Phil, the proceeds of that sale will be subject to a 2nd level of tax - a capital gains taxation (assuming that the payments are characterized as such) - which is an additional 15%. Therefore, when Jim receives the payment of $1.00 he only keeps $.85. Note that this only includes the Federal level of taxation and does not account for the additional state capital gains taxes or other taxes that may apply to the receipt of this income.

What is left for Jim?

What did the Government Keep?

Using our round numbers, the government kept 50 cents on the first round of taxes at the corporate earnings level and another 15 cents of tax for the income to Phil when he received the payment. This rough and conservative estimate of the government's take in this transaction is .65 cents of every $1.50.

A simple equation gives us the relevant percentage:

$$\frac{.65}{\$\,1.50} = \underline{43.3\%\text{ of every dollar}}$$

Another way of looking at this is to see that Acme needs to earn $1.50 for Jim to end up with $.85 in his pocket (again, excluding state and other taxes).

Back to our management team . . . this structure imposes an additional weight on the earnings and cash flow of Acme for the managers for the duration of time that these payments are being made to Jim. Therefore, Jim has, in many respects, made the difficult job of running Acme without him even more challenging by burdening his payments from the managers with two (2) levels of taxation.

Potential for Other Problems

Now, assuming that the managers make the payments to Jim, he may be indifferent because he may be thinking that he will keep the same amount of money no matter who the buyer is. But that may not be the case.

First, we can easily imagine that the managers are not able to withstand all of these tax payments and are unable to make the payments to Phil. This scenario would be every owner's nightmare who enters into such an arrangement with the management team as the lack of ability to make these payments may likely destroy Jim's post-exit plans and lifestyle.

Next, we can be proactive about this situation and, with some advanced planning, actually work to reduce the tax burden over time, providing either the managers with more cash flow, or, alternatively, providing Phil with a higher price which is, in effect subsidized by the tax savings. These advanced planning techniques are available and require the input and advice of your advisors to implement for your company.

Concluding Thoughts

Whether you want to benefit the business and managers that you are leaving behind or you want to use these planning concepts to achieve a higher selling price, there are ways to reduce the government's take and plan ahead to have a more successful exit transaction. Unfortunately, the government will be the largest beneficiary of your lack of planning. There are techniques to reduce this tax burden and it is highly recommended that you check with your advisors on ways to reduce the government's participation in your exit transaction.

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