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Elizabeth Mower:

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And I don't think that's the business owner's fault.

Elizabeth Mower:

Hello, this is Elizabeth Mower, President of the BEI.

John Brown:

And I'm John Brown, the founder of BEI.

Elizabeth Mower:

Each episode we take you into the world of exit planning, sharing the stories, struggles, and opportunities of business owners and their advisors. We'll get into this episode's conversation right after this.

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Elizabeth Mower:

Welcome back everybody for another episode of our Why We Plan Podcast. Thanks very much for being here. Today, we have another scenario of a business owner's story that I think we can probably all relate to. It's got a couple of twists and turns in it, a little bit more technical today, but I think this is helpful, even though we won't get into the real details of technical planning or complex planning. The scenario is a good one to try and kind of introduce the importance of having a team working through these issues before they show up.

Elizabeth Mower:

John, tell us a little bit about your client.

John Brown:

Thank you, Elizabeth. Right. And again, I just want to emphasize that a lot of the training we do at BEI can be fairly technical. It doesn't mean that an advisor needs to be technical, they just need to know what the issues are and then work with advisors in that field. So when we about to talk about what we're going to talk about, keep that in mind. You don't have to know a lot of this, but you have to be able to recognize the issue and have a team, somebody on your team of advisors who can address it.

John Brown:

So the scenario we're talking about actually never was a client of mine or a BEI member. It was actually somebody that came up and talked to me after I gave a talk to business owners in California some years ago. So I'd given a an hour talk on an overview of the exit planning process and all the various steps and so on. So this guy came up to me afterwards. He said, John, he said, I'm going to tell you something. I said, what's that? He said, well, he said, I have, he had this business that developed and sold software to the commercial real estate industry or profession.

John Brown:

And he said, about three years ago I decided to sell my business and I had it valued. It was worth $8 million. So I said what the heck, I want to go to market and I'm going to sell. He hired an investment bank or a business broker, I forgot to whom he decided to have the business sell or sell the business for him. And so hired the investment banker, started to go down the third party sale process, which we should probably describe at some point in our series of podcasts and started to get some bids in.

John Brown:

One bid was for an offer of $8 million and it was for the purchase of all the assets of my corporation for $8 million. So I said that's pretty good. I'll pay a capital gains tax. I'll have enough money. I'll have five or $6 million after the sale. That'll keep me going for a number of years. He was a young guy maybe mid 30s. Well at that point, his CPA was involved and said, well, you know, your corporation is a regular or a C corporation. If it sells the assets of the corporation, there's a corporate tax consequence.

John Brown:

And then for you to get the money from the sale or the sale proceeds out of the corporation after the tax, you'd pay another dividend tax. And it was California. So there's a high state income tax associated with that. So the net result, and this should probably be true, even with reduced cap, C corporation taxes today, is the net tax consequence was well in excess of 50%. So he couldn't sell. He didn't feel he could sell his company. He needed five, probably $6 million. He was going to actually get less than four.

John Brown:

So that was the story. But there's kind of a little twist to this, which I think we should also discuss. So after he finished this discussion, I asked him a question. I said, well, this was three years ago, and he said, yeah, it was about three years ago. I said, well, and he was interested now trying to maybe sell his business again. I said, have you converted to an S Corp? And he said, gosh, I don't know. That seemed to be a problem to me. So that's where we're at. Sometimes, we run into these technical issues that just terminate the sale process entirely.

Elizabeth Mower:

Right.

John Brown:

But then that doesn't necessarily mean the owner is going to do anything about it.

Elizabeth Mower:

Right. And I don't think that's the business owner's fault. I don't think that their tax structure and the tax treatment of a particular kind of business sale compared to a different kind of business sale is the responsibility of the business owner. Their responsibility is to grow a successful business and to make it into something that a buyer would want to buy. And so in that case, I hate to say it, I think the advisors let that client down because at the time that the tax consequence was realized, then somebody should have said so even the people who were trying to, the deal team, people who were trying to make a deal go through.

Elizabeth Mower:

They lose that opportunity to get a commission or a fee for selling the business. The CPA loses the opportunity to get the extra work to help the client work through the sale process. There's always work for the CPA in a transaction. Everybody loses out and nobody said, the thing is is that if right now today's not a good day for you to sell this business because of the tax consequences and what you'd end up with and it won't be enough, there's a couple of different things you could do about that. It doesn't sound like anybody said that to him.

Elizabeth Mower:

And so while a business owner absolutely in my opinion should not be required to understand that there was something that could have been done at that time in order to prepare more, more effectively for a future more successful lower tax sale of the business. There were things that could be done. It's not the business owner's responsibility. It is the responsibility of the advisors and any number of people who observed that deal sort of blowing up in front of them could have said those things. And then I might also add that a BEI advisor wouldn't necessarily know the solutions and exactly how to get them implemented, what every single thing that has to happen.

Elizabeth Mower:

I was not a tax specialist. I've never been a tax specialist. But I can promise you that if my client cancels a deal because of the tax consequences, my next question would probably be, do you think there's a way that we could do something about this so that next time around the taxes won't drive your decision to be able to sell or not sell? I might just ask the question. So I think it's the responsibility of every advisor to ask that question and the fact that it wasn't even asked is a little bit concerning.

John Brown:

So when the deal blew up, you're saying, well at least one of those advisors should have insisted, as much as we can insist, that the owner sit down, examine different tax strategies converting to an S corporation or doing something else or other tax strategies you could employ rather than just letting the owner go away.

Elizabeth Mower:

Right. That's really frustrating to me. I haven't heard the story before.

John Brown:

I actually hadn't thought of that. My thinking was twofold. One, what was seat? Clearly, this person had a lawyer at one point. I'm sure they did because they had to do some licensing work. So there was a lawyer involved, a law firm involved, and there was a CPA involved that did the taxes the whole time. This was not a real small company, so I'm sure they had a CPA. Why didn't they ever reach out and talk about the advantages of an S corporation versus the advantages of a C corporation? I doubt that that was ever done.

Elizabeth Mower:

Right. I still say even if you don't know the intricacies of the different types of entities and how they get taxed in different kinds of transactions and how transactions can be structured to manage those tax consequences. So maybe you leave your entity the same and you insist on a different structure for the transaction. There's all different kinds of things that can be done and I still don't expect necessarily for somebody to know them. But I think asking the question is there anything we can do and turning to another advisor who's maybe not very closely connected to this client and saying, I'm having a client with a real tax problem who'd like to sell his business.

Elizabeth Mower:

I was wondering, John, if you have any ideas for things that we could do differently because a sale just blew up and this client who wanted to sell the business is not going to be able to do so. So I would like to call people in my network, my sort of professional community, ask them the question. Somebody will tell me the right answer even if I don't know anything about it.

John Brown:

How about if we go back before the sale blew up, the years before then? What would you suggest we advisors do for our clients who have given no indication that they're about to exit? And this was a young owner, like I said he was probably 35, so one would not necessarily suspect that he was thinking of leaving in the next few years. Is there anything we as advisors should do really with all of our business owning clients to see if we can get a jumpstart or get some planning done ahead of time before there's an exit?

John Brown:

Should we be talking to them about exiting?

Elizabeth Mower:

Yeah. I think there's a couple of things. Let's take your same client and now back up to maybe three, four or five, seven years before that transaction process was initiated. And I'm going to say that a good business advisor is always going to ask every client what is your plan for the future of your ownership in this business? Even if the client is coming in to do their estate planning, wills and trusts, and their powers of attorney, that estate planning attorney be saying, let me just pause for a second and ask what is your plan for the future of your ownership in your business?

Elizabeth Mower:

It might affect things if there's a CPA, if there's a business lawyer who's helping develop contracts between the company and its customers or its vendors. Why don't I just ask that question?

John Brown:

And when you think about when in our surveys, our owner surveys over half of all owners surveyed regardless of age would like to exit the business within five years. So what does that mean for an estate planning attorney? Well that, I mean it has a huge bearing on how you're going to design that estate plan.

Elizabeth Mower:

Right.

John Brown:

What mean does I have for a CPA? Well if I want to leave within five years, there's a lot of tax planning that requires time, statutorily defined time like converting from a C to an S or it could be a five year built in gains issue. There are other time periods as long as 10 years before the tax planning can take full effect. So I think that's really a great idea to ask every client you have. It's a simple question. What thoughts do you have for the future of your business?

Elizabeth Mower:

Right.

John Brown:

And maybe what plans you have for your future without the business?

Elizabeth Mower:

Right. And then to follow up on that though, I think that for this client and for a lot of others, most of the really sort of sophisticated business planning advisors that I'm talking to these days, they're going to tell us that every business client that they're working with needs to be prepared for a third party sale transaction, even if they have no plans to go into one, no plans to sell the business. So most of the good advisors are helping their clients get ready as if they're intending to go into a third party sales scenario even when they aren't.

Elizabeth Mower:

So that means cleaning up the books and records of the company, making sure that everything is well documented, making sure that their processes and their business growth strategy are sustainable. And then those advisors are helping them make sure that they're successful in their marketplace, that they're competitive, their ratios when looked at against their competitors are strong. And that all of their sort of contingency planning is in place as well. And then those advisors are helping those clients look at their management team and make sure that the management team can operate successfully and independently.

Elizabeth Mower:

And those are all things that help other aspects of planning. They help you have a more successful transfer or gift to the children of the next generation in the family and they also help if you're going to keep your business forever. Those systems will help perpetuate the business to the point where you're 96-years-old and you're just tired and you're not functioning at the level that you used to and they will also help in case something happens and the client decides that they want to sell the business or a buyer just comes along out of thin air and offers a really appealing purchase price.

Elizabeth Mower:

So the really good advisors that work with a lot of business clients are recommending that piece by piece. The great thing about it is when you don't have an eminent sale, you can do it a little bit at a time just chipping away at third party sale preparedness, even for clients who have no plans to do it. Have you seen that among the advisors that you're talking to as well, John? Are you not seeing it take off as much?

John Brown:

Probably not as much as you are. Most of the members that I talk with, they're already in the midst of planning for somebody's exit. So I'm not seeing, not having those conversations with just their general clientele in the type of planning they do. But really what we're talking about is creating a business that can be transferred without losing any of its value. And that's a good topic we should explore some time.

Elizabeth Mower:

Right. So if you're a business owner, then we're going to recommend that you ask your most trusted advisors, how are you going to help me plan for a successful future of my business and my ownership? And just sit back and be quiet and see what they say. They should have an answer to that question. Do they have a method or a process that they use to help all of their business clients be ready and able to march through a successful future? And then if you're an advisor, ask your business clients, what have you done so far to prepare for the future of your ownership?

Elizabeth Mower:

In any event, quality or circumstance, could be anything that comes up. So there's all different kinds of expectations that we have. Let's start the dialogue soon and I don't really care who starts it, whether it's business owners or advisors. I just care that they're talking to each other, finding out can you help me with my future? Are you a business owner who needs some help? And then matching themselves up and working together to make a plan for the future.

John Brown:

Yeah. But one of the last things I would probably say on this is as an advisor, you don't have to know the answers. I mean, no advisor, when you ask questions about have you given any thought to the future of the business, you might be concerned they might come back with, yeah, I want to transfer the business to my daughter. I want to sell to a third party. I'm really thinking of an ESOP. And as an advisor, you may say, well, gosh, I don't even know how to respond intelligently to some of these questions that I'm getting or responses that I'm getting, so I'm not going to do anything.

Elizabeth Mower:

Right.

John Brown:

And one of the keys to effective exit planning is, well two keys, have a process and then secondly have, I call it an advisory team, but other top notch advisors of every profession that you can call, bring into a situation who can provide those answers so that between you and your advisory team, you've got the field covered. And then you're not going to be afraid of a question you can't answer because you can say that's a great question. I've got advisors I work with all the time that could really help you with that.

Elizabeth Mower:

Right. I love it when I don't know the answer to a question because it gives me an opportunity to learn something new, so I'm not embarrassed about it at all. I think that's such an interesting question. Let me go figure it out. Let me go find somebody who knows the answer and business client you can benefit from this exercise that I'll go through. So I would say we should all be encouraging our clients to ask us questions for which we don't have good answers today so that we can expand our awareness, build our relationships with some subject matter experts that we know in our area.

Elizabeth Mower:

And if you still need more expertise, you can always find an advisor at exitplanning.com. There are a lot of advisors listed there who have great depth and awareness in their technical skills in all different kinds of areas and we'd love to be able to make those connections. It makes the work a little bit more interesting and it makes the outcomes for clients better. And since BEI's mission is to benefit business owners, help business owners benefit from their lives work, I think those connections and those conversations that advisors are having and that clients are having is all part of succeeding in that mission.

John Brown:

Well, and I think that's why we plan.

Elizabeth Mower:

That is why we plan.

John Brown:

That is why we plan.

Elizabeth Mower:

Yes. So today was a little bit of technical detail and all it does is really emphasize and highlight the need for planning and that is why we plan. So we encourage you to come back again and listen to another episode of the podcast. We'll talk about more business owner stories and scenarios and ways that we can all learn to move planning forward and to help business owners have better outcomes and better futures. Thanks for being here. See you next time.

John Brown:

See you next time. Thank you.

Elizabeth Mower:

Thanks for listening. Join us for our next episode. For more content like this, please visit exitplanning.com.