

# From Entrepreneur to Investor

## Successfully Navigating the Transition



BNY MELLON  
WEALTH MANAGEMENT

# From Entrepreneur to Investor

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# From Entrepreneur to Investor

Owning and running a thriving business is akin to having a successful long-term relationship. It can be all consuming, and requires energy, passion, and commitment. Unlike a personal relationship, however, the ultimate success of a closely-held business often can be measured by the extent to which an exit strategy is effectively planned and executed. Whether the business owner sells, closes, or transfers the business to family, the termination of this relationship is one that must be carefully considered well in advance of the event.

The decision to close the doors of the business may be an easy one, informed largely by economics. The decision to sell the business outright, or transfer it to family members, on the other hand, typically is far more complicated, involving consideration of myriad financial, familial and emotional factors. Once that decision is made, the impulse is to move quickly into action: if the decision is to sell, then a deal is struck; if the decision is to keep the business in the family, then business interests are transferred. While the urge for swift action may be compelling, the prudent business owner should take pause — proceeding slowly and judiciously to make sure that both the “deal” and the family financial structure are in place well in advance of any change in ownership. Additionally, a business owner should carefully consider the lifestyle and psychological changes that accompany the move from entrepreneur to investor.

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## The Decision

The factors informing the decision to sell a business or keep it in the family fall roughly into two categories: the hard facts and the softer factors. The hard facts include issues such as: market factors, stage of business lifecycle, economic conditions, opportunities for organic vs. acquisitive growth, foreign competition, and a litany of other business indicators. Professional advisors can certainly assess these factors, but more difficult is the task of sifting through the fuzzier considerations. Less tangible inputs might include certain characteristics or life stages attributable to the business owner — changing appetite for risk, energy and enthusiasm for running the business, desire to pursue other interests, and compulsion to retain control of the business. These factors require introspection, which is often a difficult task. Some of the other soft factors include evaluation of other individuals, which can be even more difficult than introspection, especially when those being evaluated are family members or trusted employees.

The first key decision is WHO — who will be the next owner of the business? While some owners hope their business will continue in the hands of family members, it is critical to honestly assess the ramifications of this decision. The business owner must consider the business aspirations and aptitudes of the children,

the nature of the relationships among the children and the impact that would have on the business, and the nature of the business owner's relationship with his or her children. Likewise, the entrepreneur must consider the likelihood that the business will remain a viable venture if left in the hands of existing management and leadership.

## Prepare the Money for the Family and the Family for the Money

Whether the business is transferred within or outside the family, in most cases family members will be the ultimate beneficiaries of the wealth that was created by the business. Consequently, concurrently with growing the business, consideration should be given to ensuring that the children and grandchildren who will inherit the family wealth are prepared to handle it. One need not read very far in the popular press to find stories of families in which wealth has proven crippling to younger generations, rather than providing opportunities. Any complete plan for family wealth management must address issues of wealth education and stewardship, and the impact that the wealth management strategy will have on the family.

One issue that arises frequently in the context of a family business is the equalization dilemma. Is it necessary or appropriate to strive for financial equality between a child who is active in the family business and another child who has no interest in the business? There is no right answer to this question, but failing to address it can be a significant impediment to sustaining family wealth and promoting family harmony.

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The second big decision is WHEN. When is the best time to sell or gift the business? Myriad factors impact this decision. Internally, the owner and his or her advisors must assess the company's cash flow, earnings growth rate, leverage, liquidity, management bench strength and overall health. As noted earlier, the general economy, industry and other external forces are also important factors.

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The question of timing is also intertwined with the choice of who will own the business and who will receive the family wealth. If the business is to be sold to outsiders, it is often best to transfer interests to family members well in advance of the sale. The subsequent sale may not occur for a year or more, by which time the family's interests may be worth considerably more. For transfers to charity, the business owner would prefer to have a high valuation in order to receive a large charitable income tax deduction. Accordingly, charitable transfers generally are made at a time closer to the date of the sale.

The third major decision, HOW, involves the choice of tactics to pass the wealth in the most tax-efficient manner possible while achieving the family's goals. The discussion that follows explores these transfer vehicles in detail. But before the business owner spends time examining specific structures, there are some critical steps to take.

## Dealings Before the Deal

### Building the Right Team

Once the major preliminary decisions have been reached, the business owner enters a critical phase of information gathering and planning. At this point, acting too hastily can easily derail transactions. Common missteps include flawed notions of business value or sale proceeds,

insufficient allocation of resources to the transaction process, unsubstantiated projections, inadequate due diligence, inability to juggle the demands of the transaction with the ongoing requirements of the business, and failure to assemble a complete team of appropriate advisors.

Regardless of the industry or type of business, a business owner will need a common core of advisors when the decision is made to sell or transfer the business. The advisor dream team will likely include an investment banker, an accountant familiar with corporate and personal taxes, an attorney familiar with business law issues and wealth transfer matters, a business valuation specialist, and a wealth manager.

Assembling this team can be a challenging undertaking. Often, the first impulse is to engage the advisors who have been helping the business since its inception. Sometimes this can be exactly the right decision. The danger, however, is that as the business, the family and the wealth have grown, the complexities of that business and the nuances around the transfer of that business may exceed the capabilities of long-standing advisors. Prudent advisors who recognize this will be candid with the business owner about the situation, and will work to stay involved in the business while also referring the owner to a specialist. It is important to remember that bringing in a specialist does not necessitate the end of a long relationship with an advisor.

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In addition to advisor referrals, personal networks such as other business owners, are a valuable resource for referrals to qualified and specialized advisors. Of course, businesses in certain industries might require additional industry-specific assistance. Peer networks, trade associations and professional groups can be enormously helpful in identifying the need for specialized advice and finding the appropriate advisors.

Once the right team is assembled, it is up to the business owner to oversee the activities of the advisors, which begins with drafting a timeline and order of activities.

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## Assessing Family Financial Goals

Before discussions of the deal begin, the business owner and family must consider how they would like their family's wealth to work for them. This discussion can be framed around one deceptively simple question, "How much is enough?" Three questions actually exist within this one question:

- 1) How much is enough for my spouse and me (i.e., spending)?
- 2) How much is enough for my family (i.e., inheritance), and
- 3) How much is enough for my community (i.e., philanthropy)?

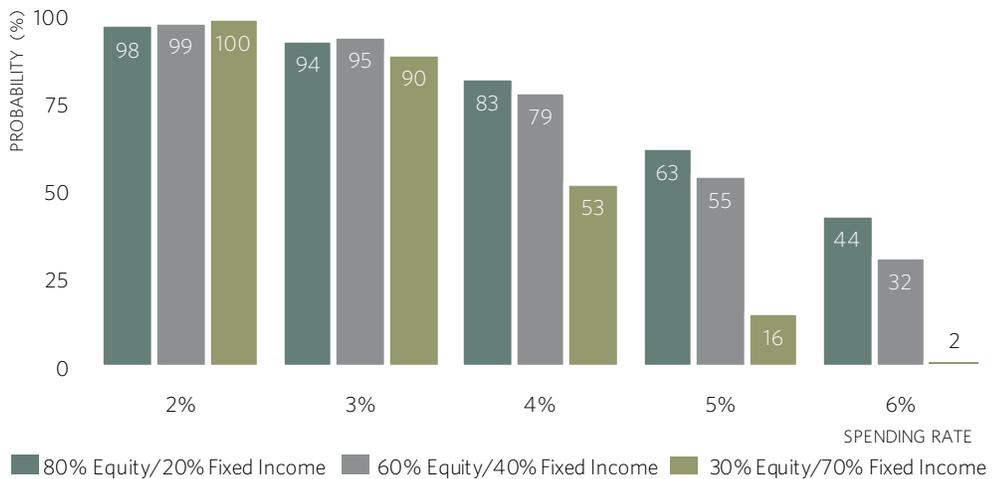
The answers to these questions will drive the family's wealth management strategy and, in turn, that strategy should have some impact on the form of the business deal or transfer. For example, if charitable giving is a priority, a stock transaction might be more beneficial than a cash deal.

## How Much Is Enough: Forecasting Your Spending Needs

Determining how to pay for a certain lifestyle after the sale of a business can be a huge challenge for former entrepreneurs. Many business owners are able to finance their lifestyle out of cash flow from the business. Upon the sale of the business, however, that cash flow dries up and the former business owner will have to rely upon the proceeds to finance his or her lifestyle. An analysis of the type of lifestyle those proceeds can support is often an eye-opening and sometimes unsettling experience.

## Impact of Spending Rate on Portfolio Value

PROBABILITY OF ASSETS GREATER THAN HALF ORIGINAL VALUE AFTER 30 YEARS



Spending rate equals stated percentage of inception market value and increases at an assumed inflation rate of 2.5% per annum. Asset allocations are constructed based on BNY Mellon Wealth Management's strategy recommendations. See endnote 1 for additional information.

## Tactics for Transferring Assets

Once the family wealth management strategy has been determined, the next step is to identify the appropriate techniques to carry out the family's goals. These techniques are created, at least in part, to mitigate taxes. When transferring assets, the transferor must contend not only with federal estate tax, which is a tax on the value of assets transferred at death, but also federal gift tax, which is a tax on the value of assets transferred during the transferor's life. Gift and estate taxes will be referred to herein as transfer taxes.

## Transferring the Business to Family

The techniques available to transfer assets within the family in the most transfer-tax-efficient manner fall roughly into four categories:

- Outright gifts
- Discounted gifts
- Gifts in trust
- Sales

Keep in mind that what follows is a broad overview of some complicated structures. Any technique of interest should be discussed in greater detail with the appropriate tax and/or legal counsel.

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## Outright Gifts

An outright gift is a direct transfer of some or all of a transferor's interest, unencumbered by any other entity. For example, Bob owns all of the 100 outstanding shares of stock in Happy Day Baby Food, Inc, and Bob decides to give 40 shares to his son. The stock is worth \$10,000 per share. The outright gift is attractive for its simplicity, but likely will not afford as wide an array of discounted valuation opportunities as do other techniques. Also the gift tax consequences of an outright gift should be considered.

## Discounted Gifts

By simply placing shares of the business in another entity and gifting interests in that new entity, the business owner might be able to take advantage of more significant valuation discounts. Consider Bob again, and assume that Bob decides to contribute all of his Happy Day shares to a family limited partnership (FLP) and takes, in return, a 1% general partner (GP) interest, and a 99% limited partner (LP) interest. Further assume that Bob gives a 40% LP interest to his son. As GP, Bob maintains control over the stock owned by the FLP and, as a LP, Bob's son has no control over the FLP assets, but is the owner of the wealth represented by his LP interests. The result is a shifting of wealth from Bob to his son, but retention of control by Bob.

In addition, the FLP might herald transfer tax savings. If based solely on the underlying assets, the value of the gift, for transfer tax purposes, would be \$400,000. Placing the stock in the FLP "wrapper," however, creates opportunities for valuation discounts, including: lack of marketability discounts, lack of control discounts and minority interest discounts. In the above situation, Bob might be able to claim a 35-40% valuation discount, so that the value of the transfer, for tax purposes, would be approximately \$250,000. This technique is particularly effective when timed correctly with an asset that is anticipated to appreciate rapidly. In Bob's case, the perfect scenario would be for Bob to create the FLP with his stock well in advance of any type of Happy Day transaction, and then, at some point after the transfer of the LP interests, have Happy Day experience some event that causes appreciation (e.g., sale or IPO). In that case, the value of the wealth transferred would be based on a low stock price and would include multiple discounts. In addition, the future appreciation would be excluded from Bob's estate.

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## Placing the stock in the FLP "wrapper" creates opportunities for valuation discounts.

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A word of caution is appropriate here — the valuations available through the use of a FLP or similar tool, such as a limited liability company (LLC), are incredibly complex and will vary from case to case. Congress, the Administration and the IRS have been directing increased attention to these entities, and additional attention from the IRS is rarely positive. FLPs and LLCs continue to be viable wealth transfer techniques, but any business owner considering them must be working with sophisticated advisors, must honor the formalities and structural requirements of the entity, and must be aware of the potential for future restrictions on these vehicles.

## Gifts in Trust

Creating trusts and funding them with business interests also can have tremendous transfer tax advantages. The most basic type of trust planning involves transferring assets to an irrevocable trust for the benefit of a group of beneficiaries. Bob might create an irrevocable trust for the benefit of his sons, and fund the trust with shares of Happy Day. The trust could be drafted to meet Bob's wealth transfer goals. For example, the trust might direct that the sons receive all income from the trust assets and have the ability to receive distributions of principal for certain needs, such as, education, starting a business, or buying a home.

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The trustee of the trust controls the trust assets, and, in Bob's case, the trustee would also have control of the trust's Happy Day shares. This may provide an opportunity to grant some control of the business to Bob's children, by making them co-trustees. Alternatively, Bob could name a trusted advisor as trustee, effectively providing Bob's children with the benefit of the Happy Day shares, but not affording them control. The issue of trustee selection is critically important, immensely technical, and can dramatically impact the management of the shares within the trust. For this reason, any business owner engaging in trust planning must think carefully with his or her advisors about the range of possible trustees.

Trust planning should be undertaken well in advance of any event that would increase the value of the interests transferred, such as an IPO or sale.

The tax advantage derived from trust planning is realized when the trust creator, or grantor, shifts assets out of his or her estate into a trust. In Bob's case, he has moved shares of Happy Day from his estate

into the trust. Because that transfer is taxable for gift tax purposes, the transfer is most effective when the interests have the lowest possible valuation. Therefore, trust planning should take place well in advance of any event that might increase the value of the interests transferred, such as an IPO or sale.

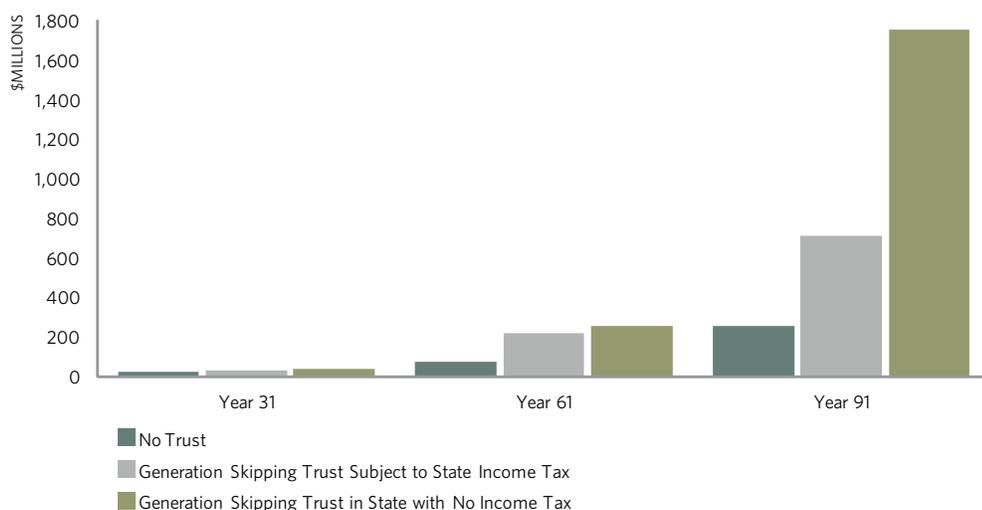
## Dynasty Trust

A variation on the general trust planning theme is a Dynasty Trust, so named because these trusts have the potential to last forever. For many years, trusts were subject to arcane laws that limited their duration; generally, trusts could last for about 100 years. In the recent past, certain states have passed laws that allow trusts to have perpetual life, hence the Dynasty Trust moniker. While a number of states have such legislation, perhaps best known is Delaware, which is characterized by a body of well-developed trust law. If structured correctly, a Dynasty Trust will allow the grantor to transfer assets into the trust, and those assets can remain in trust for many generations, insulated from state income and estate taxes.

Dynasty Trust planning can have a remarkable impact on a family's long-term wealth. For example:

## Dynasty Trust Planning

COMPARISON OF WEALTH AVAILABLE TO FUTURE GENERATIONS



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The graph illustrates another key point in trust planning, which has to do with state income taxes. A funded trust is considered a taxpayer and as such its assets are subject to income tax. The taxation of trust assets, however, varies from state to state. Some states subject trust assets to the same tax rates that apply to an individual taxpayer; at the other end of the spectrum are states that do not tax trust assets at all. It is the tax-free growth that makes the results illustrated in the graph so dramatic. The varying tax treatment from state to state is just one of several reasons that the selection of controlling state law, or trust situs, is so critically important. Selection of the correct situs must take into account the character and location of trustees, beneficiaries, grantors, and trust assets. This analysis can significantly benefit future generations of beneficiaries.

## Grantor Retained Annuity Trust

The grantor retained annuity trust (GRAT) is an advanced trust technique that allows for leveraged gifting due to a disparity between assumed growth rates in the economy and expected asset-specific growth rates. A GRAT is a means of wealth transfer that allows the shifting of wealth in a tax-efficient manner. The GRAT basics are these:

- Business owner creates a GRAT, and the GRAT document directs how long the GRAT will last, the amount of the annuity payments he or she will receive from the trust, and what will happen to the trust assets upon termination of the GRAT

- Business owner funds the trust with company stock, hopefully in contemplation of rapid growth of the stock value
- Upon funding the GRAT, the IRS looks at the size and duration of the annuity the GRAT will pay to the business owner, as well as the prevailing interest rate (known as the IRS Section 7520 Rate) at the time of the transfer, and determines the value of the remainder in the GRAT at the point of termination
- Finally, the IRS determines the value transferred for gift tax purposes based on the remainder calculated

At that point, the business owner pays any gift tax that is due, and the trust begins to operate — meaning the business owner receives the annuity payments, and the trust lives out its term. Once the gift tax is paid at the initial funding of the trust, there will be no further transfer tax due, regardless of how the trust assets perform. The tax efficiency, therefore, is achieved if the return on the assets contributed to the trust exceeds the Section 7520 Rate. If this occurs, the trust will have more assets upon its termination than was projected by the IRS, and that excess amount is essentially a transfer-tax-free gift.



For example, assume that Bob creates a GRAT and funds it with Happy Day stock worth \$1 million. The GRAT will last for 10 years, and Bob will receive an annual payment from the GRAT of \$111,326 for each year of the GRAT term. The IRS would look at the term of the trust, the amount contributed, the amount of the payments, and the prevailing interest rate, which is a proxy for the rate the assets will grow inside the GRAT. For this example, the rate applied is 2%. Given all of those inputs, the IRS will determine that at the termination of the GRAT, there will be no assets left to pass to the beneficiaries, or, in this case, Bob's children. As such, Bob has made no gift in the eyes of the IRS, and all gift tax matters with regard to this trust, have been settled. If the Happy Day stock actually does grow at 2% each year, there will be nothing left for Bob's kids at the end of the GRAT term. If, however, Happy Day experiences some appreciation event during the GRAT term and grows at say 8% per annum, \$546,200 will pass to Bob's children. In this 8% return scenario, the original gift tax calculation will apply, in effect allowing over \$546,000 to transfer from Bob to his children, free of gift tax. The general rule is that a GRAT will be a successful wealth transfer technique if the actual growth rate of the GRAT assets exceeds the rate assumed by the IRS. At the time of this writing, prevailing low interest rates make GRATs particularly attractive planning tools.

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There is one additional consideration that is crucial - for a GRAT to succeed as planned the grantor must survive the term of the GRAT. Should the grantor die before the scheduled termination date, a portion of the value of the GRAT is then includible in the grantor's taxable estate. This reduces the benefit of this technique. So, in this example, Bob should be reasonably confident he will survive the 10-year term.

The GRAT is useful for a business owner who wishes to transfer business interests to his or her family at a point prior to some event that will cause rapid appreciation. Contributing company stock to a GRAT in advance of a sale of the business is an ideal use of the technique.

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Generally, a GRAT will be a successful wealth transfer technique if the growth rate of the GRAT assets exceeds the rate assumed by the IRS.

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At the time the GRAT is created, the business owner has many options as to the disposition of the assets upon the termination of the GRAT. The GRAT

document may direct that the assets pass outright to the children of the business owner, or could direct the assets into follow-on trusts that would provide for the children's benefit. Obviously, if the GRAT assets were to pass outright to the children, then the children would control those assets and, in the case of company stock, would be able to vote those shares. If the assets were to pass to a follow-on trust, the trustee of that trust would control the assets, which might afford some opportunities to appoint a business colleague to oversee business assets owned by the trust. Providing for grandchildren and more distant generations through a GRAT can be a challenge due to technical rules surrounding the generation skipping tax (GST), which is yet another tax in the arcane transfer tax system.

## Sales

The techniques described above involve the gratuitous transfer of an asset to family members, in other words, a gift. Many business owners decide for one reason or another that they are not in a position to, nor are they inclined to, make a gift of a business interest. In these cases, a sale of some portion of the business interest can be the right tool. The sale of business interests can be as varied in form and shape as the businesses involved, but there are a few general tools.

### Outright Sales

One tool is the outright sale — a simple transfer from party A to party B for fair value. If Bob sold shares of Happy Day to his son, he would receive payment in return, and Bob's son would own the shares outright. Bob would also be faced with capital gains taxes upon the sale. If Bob was interested in deferring that capital gains tax, he and his son might enter into an installment sale obligation. Under that arrangement, Bob would sell the business interest to his son in year one, but payments would be made to Bob over some term, perhaps a 10-year period. The capital gains bite would then be spread over a 10-year period. The installment sale is a basic technique that is popular with a large number of business owners for its simplicity. It is not without technical pitfalls, however, so a business owner must engage appropriate counsel to ensure that the deal is structured correctly. Failure to do so can carry adverse tax consequences. This analysis is particularly important now, during the period of lower personal income tax rates.

### Sale to Intentionally Defective Grantor Trust

Another popular technique is the sale to an intentionally defective grantor trust (IDGT), which involves the sale of business interests to a trust created by the business owner, generally for the benefit of his/her family. An IDGT is an irrevocable trust that is not included in the grantor's estate for estate tax purposes, but the income of which is taxed to the grantor. This taxation structure occurs because the grantor retains certain powers

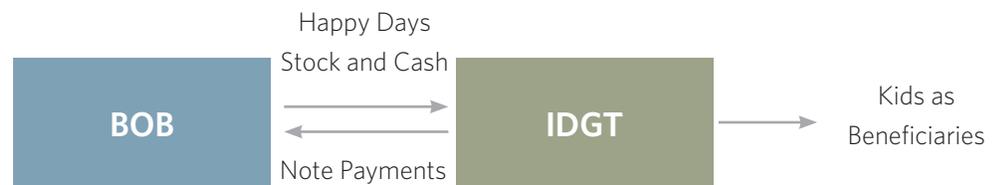
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that render it less than a total transfer for income tax purposes, or, in tax parlance, defective. Typically, a business owner would create the IDGT, and sell business interests to it in return for a note. There are other ways to structure the payments from the IDGT to the original business owner, like a private annuity or self-canceling installment note (SCIN). The use of a private annuity or SCIN, however, might bring unfavorable tax consequences to the grantor. The grantor should discuss these issues with his or her tax advisor.

Once the business interest is sold to the IDGT, the business continues to operate and, hopefully, generates enough cash to pay the debt owed to the grantor/seller. If done correctly, the structure of the payments to the grantor can serve to defer the capital gains recognized by the grantor, as with an installment sale. If the business is sold in the future, the proceeds of the interest owned by the IDGT will be available for its beneficiaries, presumably the family of the business owner. The fact that the trust's income taxes are the obligation of the grantor offers an additional transfer tax advantage for two reasons: because the grantor is paying the taxes due by the trust, the growth of the trust assets will be income tax-free and should result in a greater amount of assets passing to the IDGT beneficiaries, and the payment of the taxes by the grantor is effectively a tax-free gift, moving assets out of the grantor's estate with no gift tax cost.

The IDGT allows the business owner to fix the value of the business in the estate at the amount of the note between the IDGT and the business owner; no gift tax is due on this transfer. If the assets in the IDGT subsequently increase in value, that appreciation will be out of the estate of the grantor. Again, timing of this transfer technique is critical, and shifting interests to an IDGT well in advance of any event that will boost enterprise value will yield the greatest tax benefits. The following example illustrates this technique.

Assume that Bob has \$900,000 of Happy Days stock with basis of \$100,000. Bob creates an IDGT with his children as beneficiaries and his brother/business partner as trustee. Bob sells his stock to the IDGT for a \$900,000 note and makes a gift of \$100,000 cash to the IDGT. The note has a 9-year term, an interest rate of 1.8%, and allows for interest only payments with a balloon payment at the note's end. If the assets in the IDGT grow at 8%, the children, as beneficiaries, will receive \$635,189 free of gift tax, and Bob will have converted part of his stock position to cash. Additionally, Bob's brother, who is very familiar with the business, will control the stock owned in the trust.



## Transferring the Business Outside the Family

### Selling the Business Outside the Family

Here again, the tactics are impacted by the initial decision concerning the transferee. If an employee or employees will be the new owners, the structure often takes the form of a leveraged buy-out or an ESOP. However, more often, when the transfer is not to family members, the business owner is structuring an outright sale to an outside buyer. The negotiations during this phase are more an art than a science, and experienced advisors can play a crucial role in a successful outcome.

### Structuring the Deal

There are many ways to structure the sale of a business. Buy-outs, often by private equity groups, have been very popular in past boom eras and are reviving again with the improving economy. Alternatively, the business could undergo a tax-free reorganization such as a merger or stock swap, or it could be recapitalized. Buy-sell agreements are also a form of restricted sale.

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Possibly the most contentious issue between buyer and seller is the relative benefit of an asset sale versus a stock sale. Purchasers usually prefer to buy the specific assets of the company. This limits their liability for past activities of the business, and allows them to depreciate the assets from their purchase cost. Conversely, in a sale of company stock, the seller would typically incur predominantly capital gains rather than ordinary income tax and would avoid the hassle and lingering liability of still owning the shell of the original company. Negotiations over this issue can become quite complex, as there are various alternatives that can offset some of the negatives to buyer and/or seller in both asset and stock sales. These include, for example, techniques for the seller to mitigate the tax burden under an asset sale.

Another major decision for the business owner is how much of the company to sell and how fast. If the owner is tired of the business and eager to move on with new endeavors, he or she may be eager for a complete sale with minimal strings. On the other hand, many business owners prefer to phase out gradually, retaining an ownership interest and possibly an ongoing working relationship with the company. This can be formalized in a number of ways, such as employment or consulting agreements. Discussions regarding earn-out provisions and hold backs can figure prominently in these negotiations.

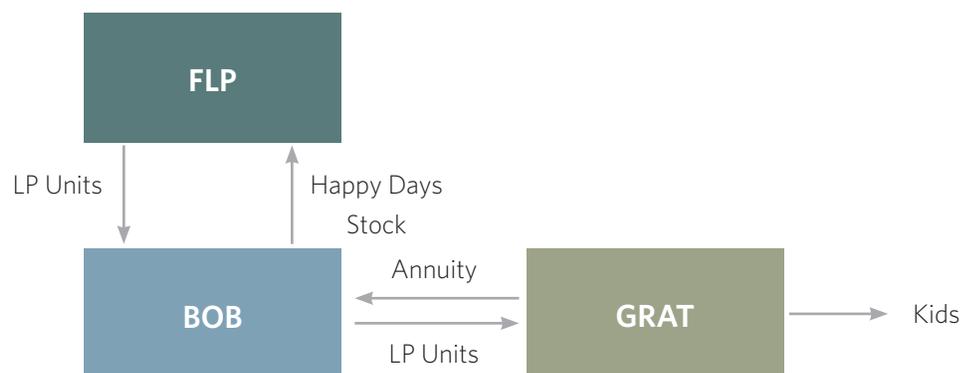
There are also a host of other details to work out between the business owner and the prospective purchaser. These include:

- Amount of cash at closing
- Seller financing
- Possible installment sale
- Seller taking back buyer's stock
- Non-compete agreements
- Handling existing buy-sell agreements

Clearly many of these items present significant potential risks and tax implications for the business owner. Having a team of experienced advisors to lean on is paramount to a successful outcome.

## The Sum of the Parts Is a Whole Lot of Value

The techniques discussed above were all considered in isolation, but optimal pre-transaction planning may involve combining multiple techniques to exploit the best aspects of a number of strategies. For example, a business owner might transfer the family business to a FLP, and then contribute FLP units to the GRAT. In that case, the transfer tax value of the contributed asset, the LLC units, could be reduced when compared to a contribution of shares of the company. The tax benefit of the GRAT may be even more pronounced if a discounted initial value of the contribution is available. This type of very basic planning could potentially result in an additional \$10 million of assets available to Bob's children 10 years after the sale of his business, as opposed to doing no pre-transaction planning. The illustration below tells the story.

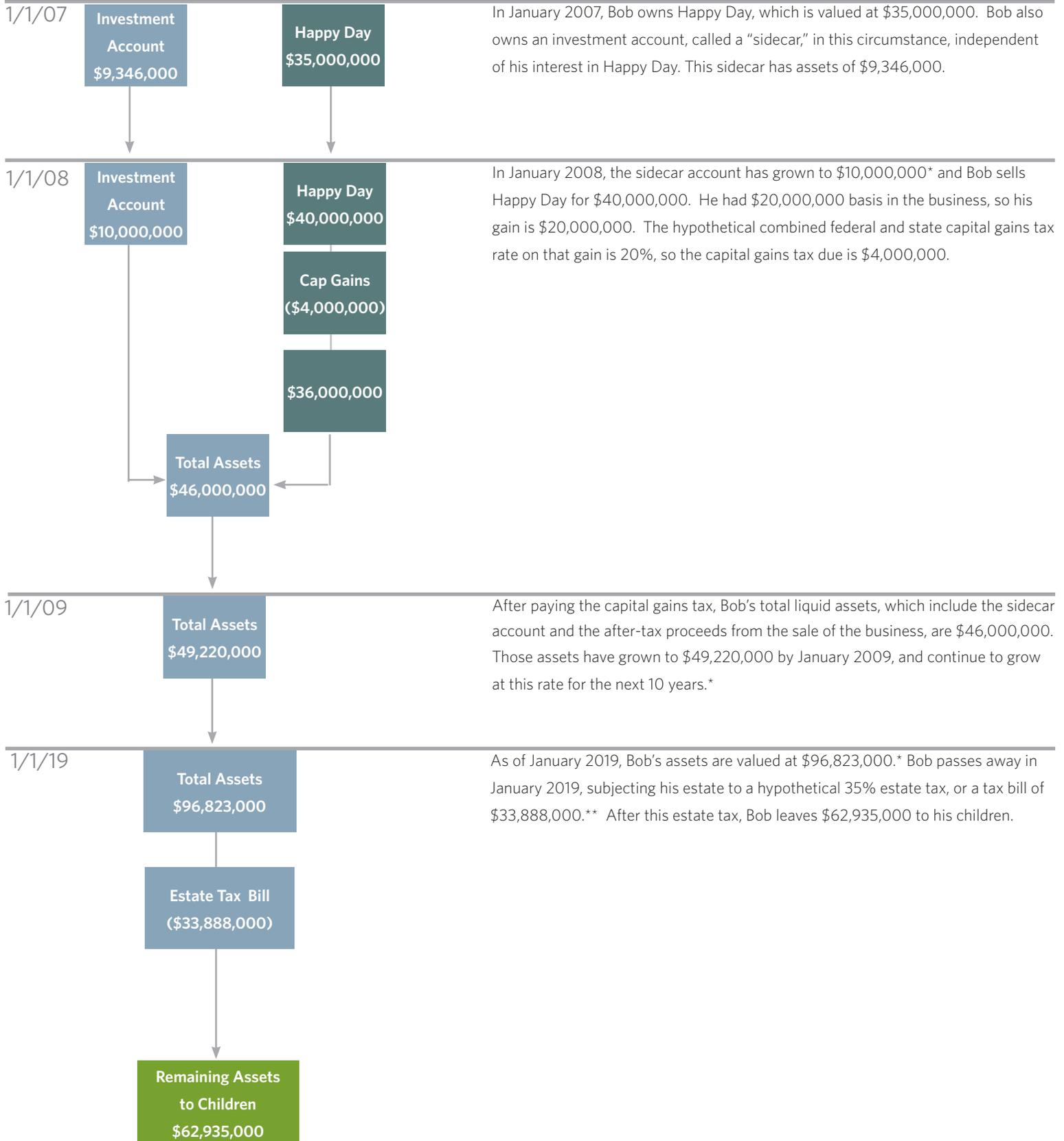


It is also important to be aware that the benefits of some of these structures may be curtailed in the future, if proposed tax reform legislation is enacted.

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## NO PRE-TRANSACTION PLANNING

This example demonstrates the outcome of no pre-transaction planning. Bob simply sells the business, pays the capital gains taxes, and holds the assets until his death, subjecting those assets to estate taxes before passing the balance to his kids. Let's walk through this option, step by step.



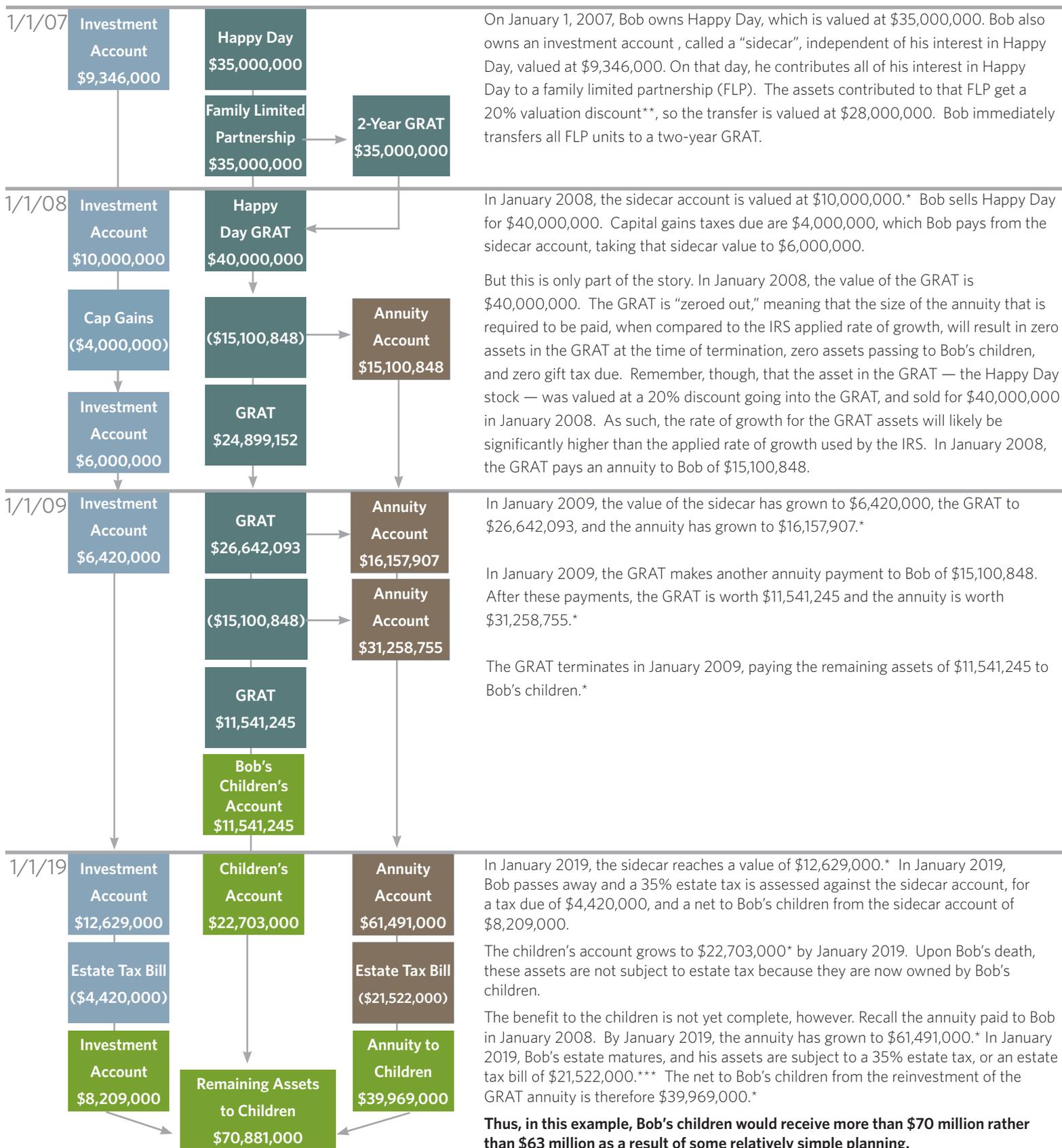
\*All assets assume an annual growth rate of 7%.

\*\*Assume no estate tax exemption remaining at Bob's death.

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## PRE-TRANSACTION PLANNING

This example demonstrates the value of some basic pre-transaction planning. With just a bit of effort, Bob can significantly increase the wealth passed on to his children. Again, a step-by-step treatment of this example is likely most useful.



\*All assets assume an annual growth rate of 7%. \*\*A word of caution is appropriate here - the valuations available through the use of a FLP or similar tool, such as a limited liability company (LLC), are incredibly complex and will vary from case to case.

\*\*\*Assume no estate tax exemption remaining at Bob's death.

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## Life After the Business

Prior to the sale, restructuring, or transfer of a business, much attention is paid to the details of the transaction and to the subsequent structure of family finances. In most cases, however, little attention is paid to what the business owner will do after the sale of the business. In reality, myriad issues arise when a type-A business owner transitions from running the business. Some of the most common issues are concerns about relinquishing control and the need for a continued sense of fulfillment.

## Control

Most successful business owners are successful because they have dedicated themselves almost entirely to running their business. The owner knows where every asset is, intuitively understands the cash flow patterns, and can almost predict the profit and loss. She or he turns the lights on every morning and can feel and touch the business' assets. A big part of the transition for a business owner is leaving this comfort zone in order to attend to the details of divesting the business and shifting to new investments for the future. This usually means moving from active control of all investments to being a passive investor, and that often does not sit well with individuals who have built and controlled an enterprise. One difficulty is the inability to "see" the assets in an investment portfolio. The investor of course knows what investments are

owned, but doesn't have great vision into those assets. For example, an investor in a mutual fund cannot see hour-to-hour, or even day-to-day, what is owned by the mutual fund. Even more dramatic is an investment in a hedge fund; given the highly proprietary nature of those vehicles, the fund distributes only minimal information, which can cause great discomfort to a business owner used to being in control.

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## Myriad issues arise when a type-A business owner transitions from running a business to life after the business.

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In order to reduce discomfort, it is critical that a business owner open a dialogue with a wealth manager before receiving the proceeds of a business sale. The wealth manager should be charged with understanding the needs and concerns of the business owner and creating an appropriate investment plan. That plan should be clearly documented in an investment policy statement, and — this is the key — that statement must be followed diligently once the investment plan is funded. The investment policy statement can serve as an anchor for the investor, reaffirming the portfolio objectives and strategy to mitigate uncertainty and prevent panic.

Some former business owners might find that, despite a clearly documented plan, they simply cannot resist the "buzz" of chasing a hot investment idea. That thrill seeking is okay and, if appropriate for the personalities involved, should be a part of the investment policy statement. But it should only be a small part. For most business owners, the goal for the proceeds from the sale is wealth preservation; they took extraordinary risks in building their wealth, and now are interested in ensuring it lasts. Large, speculative investments are not consistent with the objective of wealth preservation. Accordingly, many entrepreneurs-turned-investors will dedicate some part of their wealth, perhaps 5% to 10%, to a risk capital portfolio. This risk capital is to be deployed entirely at the discretion of the investor, while the wealth manager ensures that the balance of the portfolio is managed in line with the wealth preservation strategy. This approach allows the thrill of risk-seeking, while limiting the possible downside.

# From Entrepreneur to Investor

## Fulfillment: What Do I Do Now?

It is a common occurrence — the entrepreneur sells the business with thoughts of retiring to a life of leisure, only to wind up starting another business shortly thereafter. This is endemic of the type of personality often seen in entrepreneurs — they are not comfortable being idle. This might seem like a trivial issue, but it is critically important to the long-term well being of the business owner and his or her family. Prior to a liquidity event, entrepreneurs should consider how they will fill the days after their business is gone.

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The answers to this question are as varied as the personalities of business owners, but the answers all come down to allocation of time and resources. They also come down to priorities. Business owners must consider what they value and determine how to apply their considerable

talents to those values. A business owner who moves out of the business at age 55 can expect to have many productive years ahead. This time could be spent traveling, pursuing philanthropy, spending time with grandchildren, starting a new business, advising nascent businesses, or managing a portfolio of private equity investments.

More and more, the post-business lifestyle seems to be a combination of the above activities. As a result, a cottage industry has emerged to assist with these kinds of transitions and advise business owners and executives on “next stages.” Many of these specialists advocate a comprehensive life view, for instance, which mixes different life opportunities, such as paid work, leisure, family, community, and lifelong learning. This philosophy capitalizes on the fact that life after the business can be much more flexible. Instead of being constantly tied to running the company, an individual can split time among numerous activities. The key is to find the activities that match the values and preferences of the former business owner. While a relatively new ‘industry,’ these personal transition specialists can provide very valuable assistance and in some cases have come to be viewed by their clients as just as critical as the advisors engaged to manage the actual business transaction.

## Summary

The decision to step back from running a business is never an easy one, and signals the sometimes difficult movement to the next stage of life. Once the decision is made, however, the transition can be seamless if the business owner takes the time to assemble the right team of advisors and works with those advisors to make sure that the deal provides the greatest benefit to the business owner and his or her family. Part of that exercise is to think well in advance about techniques that can be employed to shift wealth as part of a long-term wealth management strategy. Timing is key in this area — waiting to think about wealth transfer until just before a transaction is closed may result in missed opportunities and diminution of the assets available to the business owner’s family.

In addition to preparing the business, the wealth strategy, and the family, the business owner must also prepare him or herself for life after the business. Traditional retirement seems to be an outdated notion to the current generation of business owners getting ready to transition away from their businesses.

With proper advice and thorough planning, a business owner can put his or her life’s work to work — to provide for the family, embark on new adventures, or to realize other personal goals for the future.

# From Entrepreneur to Investor

## About the Author

### Joan Crain

Senior Director, Wealth Strategist

Joan Crain is a senior director of BNY Mellon Wealth Management. As a family wealth strategist, Joan works closely with portfolio managers and sales officers to provide comprehensive wealth management advice to clients and their families.

Joan joined the firm in 2001 and has more than 25 years of experience in financial services, banking, and investments. Joan specializes in retirement, business succession and philanthropic planning. She has considerable experience working with large multi-generational families. She is frequently invited to speak to professional and client groups, and has been featured in numerous business publications.

Joan received a master of business administration from Rollins College, a bachelor of education from Queens University and a bachelor of music from McGill University. She is a Certified Financial Planner® professional and has earned the designations of Certified Trust and Financial Advisor and Certified IRA Specialist from the American Bankers Association. She was named as the 2009 Trust Banker of the Year by the Florida Bankers Association (FBA). She is a past chair of the Trust Legislative Committee and current member of the Executive Committee for the Florida Bankers Association. Joan also serves on the Board of Directors for the Community Foundation of Broward.

#### Endnote 1:

The 80% Equity/20% Fixed Income portfolio comprises: 29.8% large cap equity, 3.7% mid cap equity, 2.3% small cap equity, 12.0% developed international equity, 12.3% emerging markets equity, 10.2% taxable fixed income, 0.9% high yield fixed income, 2.2% absolute return strategies, 11.7% long/short strategies, 10.0% private equity, 1.6% commodities and 3.3% managed futures.

The 60% Equity/40% Fixed Income portfolio comprises: 22.4% large cap equity, 3.1% mid cap equity, 2.0% small cap equity, 9.0% developed international equity, 10.0% emerging markets equity, 28.8% taxable fixed income, 1.9% high yield fixed income, 3.1% absolute return strategies, 7.3% long/short strategies, 7.5% private equity, 1.2% commodities and 3.7 managed futures.

The 30% Equity/70% Fixed Income portfolio comprises: 13.4% large cap equity, 3.2% mid cap equity, 2.1% small cap equity, 4.5% developed international equity, 4.4% emerging markets equity, 60.2% taxable fixed income, 2.0% high yield fixed income, 4.4% absolute return strategies, 2.6% long/short strategies, and 3.2 managed futures. Return assumptions: 8.0% large cap equity; 8.75% mid cap equity; 9.5% small cap equity; 7.8% developed international equity; 10.0% emerging markets equity; 4.0% taxable fixed income; 7.0% high yield fixed income, 6.0% absolute return strategies, 7.5% long/short strategies, 12.0% private equity, 7.0% commodities and 6.0% managed futures.

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