FAMILY BUSINESS TRANSITIONS: SELLING THE BUSINESS

The likelihood of successful transitions of family businesses to the third generation and beyond is distressingly low: Less than 12% of businesses survive to the third generation.\(^1\) Put another way, 88% of businesses that hardworking family members created fail to survive two generational transitions. What are the primary causes for the dismal outcomes in transitioning family businesses? How does a business-owning family avoid becoming a statistic, prepare the correct transition strategy, and execute the critical implementation?

This discussion is the second of a two-part series exploring these questions. In *Family Business Transitions: Rising to the Challenge* we looked at reasons for the high failure rate of family business transitions across multiple generations and how families can circumvent these issues. We explored two primary reasons:

- The next generation is not interested or adequately prepared to lead the business.
- The leadership has not thoughtfully planned or prepared for leadership transition.

In this discussion, assume the family and the business are at a crossroads:

1. **First, the family must decide if the business must be kept or sold.**
2. **Second, in the event of a sale, they must determine best practices to increase the probability of a smooth, successful sale.**

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WHAT COULD PROMPT THE FAMILY TO THINK ABOUT A SALE?

Sometimes, the family receives an unsolicited offer from an interested buyer. Sometimes, the family has determined that the time is right to consider a sale for various reasons. For instance, market conditions for the sale of similar companies are favorable to sellers such that the economics cannot otherwise be replicated (a “Black Swan” event). There may be no family successor to continue leading the business. Or, in some cases, required capital expenditures to stay competitive are more than the family wants to invest. There are many reasons that might dictate exploring the possibility of a liquidity event.

With experience as our guide, we have identified a common framework of interrelated considerations that business owners should take under advisement as they seek to make the decision to sell and, if the answer is yes, to plan for and optimize the outcome of what typically is the most important financial event of their lives — the sale of the family business. The topics we address in our discussion include:

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<td>ANSWER THE QUESTION, IS THE BUSINESS AN “HEIRLOOM” OR “FINANCIAL ASSET?” THE ANSWER IMPACTS THE DECISION TO RETAIN OR SELL.</td>
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Whether a transaction unfolds in the form of a recapitalization or an outright sale of the business to a financial or strategic buyer, this discussion highlights the common threads that generally traverse all deal types. Our goal is that it helps business owners engage in thoughtful planning and make well-informed decisions in advance of a sale. It is important to note that there are also gift, estate and philanthropic strategies that should be considered, but we do not address them in this discussion.

Generally, there are three time frames, or stages, during which to consider the topics we address: pre-liquidity, the liquidity event itself, and post-liquidity. In our discussion, we focus on the pre-liquidity stage.

In addition to our broad topics, we also list key takeaways before and after the transaction. Every business owner should consider these as part of planning for the liquidity event. The significance of planning cannot be overly emphasized — the earlier the better.
CONSIDERATIONS IN DETERMINING WHETHER TO SELL

Q  IS THIS BUSINESS AN “HEIRLOOM” OR A “FINANCIAL” ASSET?

Whether market conditions or an unsolicited offer to purchase is the reason to consider a sale, in contemplating the sale of a family business the family needs to grapple with emotions that can and do emerge. Often, the business represents years of sacrifice and hard work, and the family has a strong personal connection that spans generations. It may seem that considering selling the business is a betrayal of the prior generations who have left it in the hands of future generations. It may even feel that there is an implied contract dictating that the business remains in the family. It is important to recognize emotions — including sorrow, anger, and loss — and discuss them openly as the family decides whether or not to sell the business. It may be that the current generation does not feel the same loyalty to the business and that their emotional attachment is not strong. Those in control of the decision to sell or not should ask the question, “Is this business an heirloom-legacy asset or a financial asset?” The discussion surrounding and answer to this question can help the family as it decides whether to keep or sell the business.

Q  IS THE FAMILY PREPARED TO CONTINUE OPERATING THE BUSINESS?

Are there family successors ready, willing and able to step into management and leadership roles? Are there family members able to be groomed for these roles within a reasonable timeframe? If not, is the family willing to retain a non-family executive to run the business? If the answer to these questions is no, the family should consider selling.

Q  CAN THE FAMILY AFFORD TO SELL THE BUSINESS?

A starting point in assessing the future path of the business should be establishing its fair market value. One way to accomplish this is to retain a reputable valuation firm to prepare an independent valuation. This can help level-set discussions around the likely proceeds resulting from a sale. In short, the appraised value of the business net of transaction costs and entity level and individual taxes provides a rough estimate of net sale proceeds.

It is important to note that a formal business valuation usually assumes a transaction price between a hypothetical willing buyer and willing seller, both having reasonable knowledge of the relevant facts. For the sake of the business valuation, these are facts that the business owner shares with the valuation.
KEEP OR SELL DECISION TREE

What conversations do I need to have with my family and why?

**Am I willing to part with my company?**
(Is it an heirloom or a financial asset?)

**Emotional Threshold**

- **NO**
  - How much time do I have to make a decision to hold/sell? Scenario planning

- **YES**

  **Evaluate Asset Sufficiency**

  - **NO**
    - Keep the Business
  
  - **YES**
    - **Am I willing to accept the lower cash flow from a diversified public securities portfolio?**

- **MAYBE**

  **Why does selling a private business lead to lower cash flow?**
  - Loss of financial leverage
  - Sale at lower multiple than reinvestment opportunities in the public market
  - Loss of employment compensation and benefits
  - Impact of taxes

- **Am I willing to accept the lower cash flow from a diversified public securities portfolio?**

  - **YES**
    - Sell the Business

  - **MAYBE**

    **What could raise the perceived or actual business risk to the point that this answer changes?**
    - Industry dynamics
    - Capital requirements
    - Leadership transitions
    - Disagreement among shareholders

  - **NO**

Preparer — as opposed to facts that have undergone a buyer’s due diligence. It is also worth noting that the valuation will not include a strategic buyer premium or a premium for a high quality management team, both of which could result from a well-planned and orchestrated sale process. That being said, a valuation can be a reasonable starting point for preliminary planning purposes.

The key question is, “Will the net proceeds — if invested in a diversified investment portfolio — satisfy the family’s cash flow needs compared with a view on how sustainable the company’s earnings are for future generations?”
IS IT AN APPROPRIATE TIME TO SELL THE BUSINESS?

The economy, market conditions and industry factors all impact the ability to sell a business and the relative value a seller will receive. Further, company-specific factors can also impact the timing of a potential sale. Is the company in the midst of a major initiative, such as facility replacement/expansion, new customer onboarding, new product launch, technological innovation or market expansion? Could greater value be realized for the company if a sale were delayed to allow for the benefits of the initiative to be recognized? Granted, there is an element of business judgment that comes into play in such a scenario. The potential upside in selling price must be weighed against the downside risk associated with the failure/delay of the business initiative as well as the time value of money resulting from delaying a sale.

IS THE BUSINESS READY FOR SALE?

Before diving into how to best prepare a business for sale, first know that most business sellers jump straight into the sale process without any real preparation, strategy or planning. Second, almost every business is salable. It just comes down to the ultimate purchase price, the risk/reward dynamics between the buyer and seller, and the amount of time or number of attempts it will take to get a transaction completed. If the selling business owner is interested in maximizing after-tax proceeds for the family, having peace of mind that the right decisions are being made, reducing decision anxiety, and having a smooth transaction process, some highly coordinated pre-transaction planning and preparation will be required.

For many logical reasons, numerous sellers elect to skip the pre-transaction planning stage and move straight into a sales process. The typical reasons we see this scenario are:

- The business owner received an attractive unsolicited offer
- Or experienced a major family crisis or health event
- Or failed, intentionally or unintentionally, to do substantial planning

Although skipping the planning stage is not ideal, we routinely work with business owners who find themselves in an unexpected sale process. In such scenarios, we advise them on actionable items that can increase potential value within the timeline provided. Below, we highlight several of the most basic actions sellers can take to increase the probability of completing a transaction that meets their goals.

When selling a business, many factors come into play that will impact the outcome of the transaction. Keep in mind that the seller cannot control everything. One goal should be to identify the controllable items and make sure those items will produce the expected/desired outcomes during the transaction process — and not emerge as an unexpected negative surprise during the due diligence process. Think of the deal momentum and valuation impact to your business if
a business partner changed course unexpectedly, a key salesperson left, a CFO resigned, or financial statements needed to be restated or adjusted. You should prepare and control what you can, as there are many components of a process that are beyond your direct control — such as macro-economic trends, stock market volatility and access to capital markets.

Size and scale matter.
The bigger… the better. There are no absolute metrics that apply to every business and industry situation, but typically larger businesses have greater probability of being successfully sold, and at premium valuations, than smaller businesses. Larger businesses are more robust and make more money. They are easier to leverage. They attract higher caliber external advisors, investment banking interest, yield robust sell-side processes and generate higher transaction fees. To cut to the chase, businesses with $5.0 million or more of EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) start to capture more attention.

Across just about every industry sector — excluding venture, early-stage companies and technology businesses — the old saying of “cash is king” applies. For strategic buyers, private equity buyers, investment banks and lenders, your ability to quickly and efficiently convert sales to cash is critical. As a proxy for cash flow, the starting point for most financial conversations will be based on EBITDA.

For example, if you had three separate companies in the same industry with $2 million, $5 million and $25 million of EBITDA, respectively, you would have dramatically different professional advisors, sale processes, interested buyers, private equity participants and purchase multiples for each of the businesses. Many bankers point to exceeding $5 million EBITDA as an important milestone. Surpassing this threshold is commonly cited as substantially increasing the universe of possible buyers and the probability of completing a successful transaction. Obviously, having superior operating metrics, management and financials over your peers enhance your value and the chances of completing a transaction.

Strong and stable management teams are important.
Strong, diverse management teams with a deep bench of potential succession talent are much more valuable than narrow, retirement-focused teams. Many buyers, especially private equity group buyers, place outsized emphasis on the quality of the management team and its ability to continue to expand the business. Conversely, companies with less-than-ideal management structures usually are penalized by buyers with lower-than-expected purchase price multiples. The most extreme cases typically involve owner-operators with key relationships attempting to sell and immediately retire from the business.
To illustrate this point, let’s assume one critical executive has major influence on the success of the business. Their departure might jeopardize sales, ongoing operations, profitability and the business’s very survival. Involving professional advisors early in your consideration process could help fix, mitigate or enhance the story surrounding your management team. Not every business has a world-class management team. Yet, such businesses are bought and sold every day. Fortunately, there are buyer groups that focus on these situations, as they see opportunities to enhance management teams and grow beyond the current constraints of the business.

**Evaluate financial statement and reporting capabilities.**

Earlier we touched on the concept of “cash is king” and EBITDA as an important performance metric. What is the condition of your financial statements and reporting capabilities? Are you tracking EBITDA, EBITDA margin percentages, operating trends and other key performance metrics in the ordinary course of business? Or are they an afterthought or recap of quarters past? A company that routinely tracks and can readily produce quality operating reports and financial statements with supporting analysis will be more valuable and more likely to maintain value during the financial due diligence process.

Businesses with cash-based accounting or those not following GAAP reporting guidelines will be more challenged in a financial due diligence process. Audited financial statements prepared by a reputable firm are always more valuable to a buyer than owner-prepared, compiled or reviewed statements. Northern Trust’s Business Advisory Group often advises our clients to proactively secure a sell-side quality-of-earnings report so that our client will be as prepared as possible heading into a sale process or late-stage financial diligence. Today, most buyers will demand a full buy-side quality-of-earnings report, so why not be prepared with answers before the questions are asked? Buyers use these reports to measure the quality of your reporting statements and validity of your reported numbers. If a seller is not on top of their numbers and isn’t prepared for the buyer’s due diligence process, the seller is likely to come out on the losing end of this battleground of value. You can be sure that the accountants paid by the buyer will be on the lookout for items to be used against the seller for a reduction in purchase price.

Northern Trust’s Business Advisory Group often advises our clients to proactively secure a sell-side quality-of-earnings report so that our client will be as prepared as possible heading into a sale process or late-stage financial diligence.
IS THE BUSINESS READY FOR THE DUE DILIGENCE PROCESS?

Part of any sale process will include extensive due diligence by the buyer or the buyer’s advisor. Below is a partial list of the types of due diligence material that will be requested:

- **Organization structure**: articles of organization, bylaws, minutes, annual reports, good standing certificates, list of shareholders, shareholders’ agreements, organization charts

- **Financial reporting**: financial statements, operating budgets, capital budgets, strategic plans, financial projections, mortgage/debt documents, inventory details, A/R and A/P schedules, fixed asset/depreciation schedules, sales and margin analysis by product, customer and sales territory, incentive compensation detail

- **Taxes**: copies of all income tax returns for at least the last three years, sales tax returns, payroll tax returns, excise tax returns, audit notices, tax settlement agreements, tax assessments

- **Manufacturing**: standard cost variance reports, scrap detail, product backlog reports, work-in-process detail, capacity utilization detail

- **Product information**: product list/catalog, price list, purchase order form, warranty and warranty claims detail, detail of product recalls, Inventory reports

- **Customer information**: customer list by product, sales dollars and margin, detail of advertising and marketing programs, report of unfilled orders

- **Human resources**: employee list, including position, salary history, bonuses and benefits, non-solicitation/non-compete agreements, consulting agreements, detail of all employee benefits and summary plan descriptions for all benefit plans, copies of any collective bargaining agreements

- **Real estate**: list of business properties, deeds, mortgages, title policies, leases, sub-leases, surveys, permits

- **Environmental matters**: environmental reports for each property used by the company, list of all hazardous materials used by the company, procedures for handling and disposal of hazardous materials, list of all environmental permits and licenses, correspondence with any regulatory agencies

- **Intellectual property**: list of trademarks, trade names, trade secrets/know how, copyrights, patents/patent applications

- **Material contracts**: copies of any material contract of which the company is a party, including supply agreements, distribution agreements, joint venture arrangements, marketing agreements, employment agreements

- **Litigation**: detail of any settled, pending or threatened litigation of which the company is or was a party
Assembling due diligence material can be a daunting task even with the best of record-keeping systems. It is highly recommended that a business spend time preparing for buyer due diligence before initiating a sale process.

- The business should ensure that all major contracts are in place and fully executed.
- An audit of the company’s financial statements could be obtained for at least the last fiscal year.
- A quality of earnings report could be commissioned to validate the accuracy of the company’s financials.
- Incentive-to-stay agreements could be negotiated with key employees to assure their continuation with the business.
- Key sales and management reports could be refined to assure accurate and timely information will be available to a prospective buyer.

Again, it is important to keep in mind that the availability and quality of the due diligence material will help maximize the sale price of a business and assure the timely completion of the due diligence process.

**Q** **DO YOU HAVE A TEAM OF EXPERTS TO ADVISE YOU?**

Our experience is that most business owners are experts at running their businesses but are less proficient in knowing what professional advisors to consider across a range of important services. If contemplating a sale process, selecting the right investment banker/broker to advise you through the process is one of the most critical decisions you will make. How do you know what firm to use? What criteria should you have as you consider sell-side advisors? Are you hiring the best advisor to help achieve your goals? Applying fiduciary discipline, Northern Trust’s Business Advisory Group can assist the seller’s family in selecting the most appropriate investment bank to maximize value and ensure that the transaction is done right the first time.

Even if the family or business owner is not yet ready to sell the business, going through the planning steps mentioned above is a worthwhile exercise that should pay dividends over time. Aligning the family’s vision regarding the business, creating and maintaining a capable management team, focusing on the value drivers of the business, and minimizing financial and operational risks are beneficial whether the company is sold or ultimately transitioned on to the next generation of family owners.
THE INCOME TAX CONSEQUENCES OF THE SALE/TRANSACTION UNDER VARYING PRICE AND DEAL STRUCTURES

TAXES — THE LARGEST TRANSACTION COST

In addition to deal-related issues to complete the transaction, business owners should consult with their tax advisors early and begin to plan for the implications of their shift from operators to investors. The events that occur before a transaction takes place can have a significant impact on the after-tax proceeds available to the selling owners. To maximize the benefits of the transaction from an income, estate and financial perspective, strategic planning is required. This type of planning takes time, so owners need to start the discussions with their tax advisors in advance of the transaction.

THE LAUNDRY LIST OF TAXES

Before getting into the nuts and bolts of minimizing the taxes that can result from the liquidity event, it is helpful to review the possible taxes that can apply to the transaction itself as well as the potential taxes that can apply after the event:

- Top Federal Marginal Rate for Ordinary Income — 37%
- Top Federal Capital Gains Tax Rate — 20%
- Federal Medicare Tax on Net Unearned Income — 3.8%
- Additional Federal Medicare Tax on Wages and Self-Employment Income — 9%
- Real Estate Depreciation Recapture on Sale of Real Estate Used in Trade or Business — 25%
- Top State Income Tax Rates — California is now the highest, at 13.3%

The ability to plan for the tax ramifications depends on the how the business is owned and the composition of the assets within the business. It is crucial, therefore, to have a thorough understanding of the operating structure in order to coordinate the liquidity event in the most tax-effective manner.

While beyond the scope of this discussion, a business owner also needs to consider the potential impact of wealth creation on future estate and gift taxes. The pre-liquidity period may provide an opportunity for the business owner to implement gift and estate tax planning strategies that take advantage of favorable minority interest discounts in advance of a liquidity event.

2 There is considerable complexity in this area where pass-through entities are involved, so it is important to consult with your tax advisors regarding the application of the Federal Medicare Tax on the disposition of equity interests in such entities.
COMPOSITION OF ASSETS AND YOUR CURRENT OWNERSHIP STRUCTURE

Sale of Business to a Strategic Buyer — One of the drivers that will affect the desired outcomes for the sales transaction is the legal and tax structure of the business. Is the business operated as a regular C corporation or an S corporation? Is it housed in a limited liability company, a partnership, or operated as a sole proprietorship? Depending on the answer, the structure of the sale and the resulting tax consequences can be dramatically different. For example, if the legal entity is a C corporation, the seller typically prefers a stock sale as opposed to selling the assets of the corporation to a third party purchaser. One reason is that the proceeds of a stock sale are generally taxed at capital gains rates. Another reason is that if the transaction is instead structured as an asset sale, there will be two levels of tax: one at the corporate level for the assets sale at a 21% federal corporate tax rate plus state taxes and one at the shareholder level for the distribution of the net proceeds to the shareholder.

The purchaser, on the other hand, generally prefers to purchase assets rather than stock. By buying the assets of the corporation, the purchaser is able to obtain a basis adjustment for the purchased assets for depreciation purposes. Additionally, if the purchaser buys the corporate assets instead of the owner’s stock, there is little risk that the purchaser will be subject to corporate liabilities that are not known at the time of the purchase.

If the legal structure is a pass-through entity such as an S-corporation, a limited liability company or partnership, there will be only one level of tax imposed at the time of a sale. But the seller and purchaser will still likely want to structure the transaction as a sale of the interest in the entity (seller) or an asset sale (purchaser) for the same reasons identified above.

Assuming the purchaser is insistent on buying the assets of the business entity, the purchase price must be allocated among the assets purchased. Assets can include cash, inventory, receivables, equipment, furniture, goodwill, intellectual property, covenants not to compete, and real estate. The gain or loss from the sale of such assets will be subject to different tax rates depending on the type of asset sold. In an asset sale, whether the business is operated on a cash basis or accrual basis can also affect the tax rates that apply to the gain or loss on the assets sold. For example, a cash basis seller of receivables will have ordinary income whereas the accrual basis seller will have full basis in the receivables and should not have any gain upon the sale. Assets that have been depreciated or amortized will subject the seller to a recapture of such past depreciation and is usually at ordinary income tax rates depending on the type of asset (e.g., equipment is taxed at ordinary income tax rates, and most real estate is taxed at 25%).

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3 If the S corporation was converted from a C corporation and the effective date of the S-Corp election was less than 5 years prior to the contemplated sale, there will be a corporate level tax imposed on the assets sold.
For sales of assets in pass-through entities, understanding the various tax rate consequences is critical to the business owner, who may end up paying tax on the sale at ordinary income tax rates (up to 37% for federal tax) rather than at the lower capital gains tax rate (up to 20% for federal tax).\(^4\) When you couple the federal tax rates with the state income tax rates (in some states as high as 13.3%), the asset sale can produce a much higher tax and can have a dramatic effect on the business owner’s expected after-tax benefit. Armed with this information, the seller may wish (and most do) to negotiate a higher price for an asset purchase in order to compensate for the higher tax “price tag.” However, this often requires some form of competitive sale process to do it well.

**Real Estate Used by Business: Ownership Issues** — It is not unusual for business real estate to be owned outside of the operating company. Often, the real estate is owned by the business owner individually or in a separate entity and leased back to the operating entity. When contemplating the sale of the business, attention must be given to what to do with such real estate. Does the business owner sell the real estate to the purchaser of the operating business or does the business owner retain the real estate and continue leasing the real property to the operating business after the sale?

If it is decided that the real estate will be sold, then, depending on how title is held, the sales proceeds will be taxable to the owner of such real estate. If owned individually, there will be only one level of tax. If owned in an entity, then the same considerations discussed above will determine whether there is one or two levels of tax. Finally, if the real estate improvements have been depreciated over time, then a portion of such depreciation is recaptured. This generally occurs at a tax rate of 25%, with the amount in excess subject to the regular capital gains tax rate.

If the business owner decides to retain ownership of the real estate and lease it back to the operating company, it is important to note that the lease payments may be treated as passive income and, when added to the business owner’s other investment income, could trigger the 3.8% Medicare surcharge tax if care is not exercised to ensure that the owner is actively managing the real estate.

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\(^4\) The capital gains tax is still the preferable tax rate even with the potential imposition of the Medicare surcharge of 3.8% on net investment income that was added as part of the American Taxpayer Relief Act of 2012 on net investment income amounts in excess of certain thresholds.
WHAT WILL I GET?
DEAL STRUCTURE CAN DRIVE TAX AND ECONOMIC RESULTS

Is this an all cash deal or will there be installment payments, earn-outs and the like? Knowing the answers to these questions can provide directionality in terms of taxation, risk, deal structure and cash flow. In terms of risk, most sellers want all cash at the time of sale. If the purchaser cannot provide all cash and an installment sale is mandated, the seller has more risk if the new owners do not run the business as profitably as the prior owner and the risk of default on the note is higher. Although the stock sold is typically the collateral for the installment note, the seller may want to ask for additional collateral to protect the payment of the future installments.

The seller and purchaser may not always agree on the purchase price. In such instances, the transaction may be structured with an up-front payment and additional earn-out, or contingent payments made when certain milestones in the business are met. Although the initial upfront payment is treated as the sale of a capital asset, portions of the subsequent payments are likely to be treated as imputed interest and taxable as ordinary income. Additionally, when there are contingent payments, the seller may utilize the installment sales method — but special rules apply to spread out the seller’s tax basis to later years, when contingent payments are made. The problem is that by moving the tax basis to later years, the seller must pay more in upfront taxes. There is a risk that the basis may be unutilized in later years, due to less than anticipated contingent payments, resulting in a future capital loss, which may be of limited use. In some instances, the seller may need to consider electing out of the installment method. Understanding the tax ramifications of these payments may require negotiation of the price to compensate the seller for the higher taxes that will result from structuring the transaction in this manner.
THE IMPACT AND CHANGE IN CASH FLOW TO THE FAMILY UPON EXECUTING THE TRANSACTION

MAKING THE SHIFT FROM BUSINESS OWNERS TO WEALTH OWNERS

As a business owner, your current cash flow is typically derived from a number of sources, including wages, dividends or distributions and rents. It is important to plan ahead to determine how these cash flows and your overall capital profile will change. In almost every case, a material "mental shift" will occur when converting to a liquid base of capital from an operating company structure. The foregoing list of wages, company distributions/dividends and various other cash streams are often transformed into a sizable pool of capital from which to support your future goals and objectives. By envisioning and planning for this shift, you can become more confident in your decision making.

Creating a process to determine whether you and your family will have sufficient resources to achieve your financial and estate planning goals provides you with the clarity you will need in making your decisions about spending, investment allocation, gift, estate and philanthropic planning. No one knows for sure what the future will bring, but setting goals and establishing a discipline around investing and budgeting will increase the probability that you will have sufficient financial assets to meet your lifestyle objectives. This kind of analysis is not a one-time event, but a process that will need to be revisited over time as circumstances and assumptions change.

Asking and answering the right questions and then setting goals and objectives are the starting points in this process. In thinking about one’s goals and objectives, we generally view the world within four “mental accounting buckets.”

1. **CORE LIFESTYLE**
   - General lifestyle goals of food, clothing, shelter

2. **DISCRETIONARY**
   - Second home purchase, vacations, art, aircraft

3. **FAMILY**
   - Funding your children's education, gifts to children, parents, other family members

4. **PHILANTHROPIC**
   - Gifts to support and/or promote charitable/social endeavors
Most individuals would argue that their highest value goal is clearly to protect and preserve their core lifestyle goals. To that end, performing a scenario analysis, or “dry run,” of the after-tax proceeds you would receive from a transaction under base case, best case and worst case scenarios is imperative. Using the results of this dry run analysis, you can then seek to determine capital sufficiency in meeting those lifestyle goals.

A capital sufficiency analysis should seek to solve for your “core lifestyle capital” — that amount which, when allocated and invested prudently, will allow you to spend what you need to spend each year, indexed for inflation. Once you have determined the core lifestyle capital you can then determine if you have excess capital to fund the other categories of capital: discretionary, family and philanthropic.

| Total Capital | Core Lifestyle Capital | Excess Capital |

Questions that may need answering: What does my financial picture look like if I sell? Will I have sufficient sales proceeds to take care of me and my family for the rest of our lives? What sales price do I need to ensure that I have sufficient resources to meet my goals? What sources of income will I have post-liquidity event to substitute for sources that are cut-off by the liquidity event? Will this event be an all-cash sale, an installment sale, will there be earn-outs or contingency payments? Will I continue to be employed for a period of time after the event? Can I maintain my current lifestyle without exhausting my financial resources? What are the levels of my liquid and non-liquid financial assets now, and what will they be post-event? Will I be able to fund my children’s college education, a down-payment on a home, transfer funds to a private foundation, make a significant gift to my children and/or grandchildren without jeopardizing my financial future? How will my income tax situation be impacted by the liquidity event?

By grappling with these questions, prioritizing your needs and running various scenarios using reasonable assumptions of investment returns and tax rates, you can plan your investment and spending strategy for the rest of your life with a level of confidence. This analysis can inform how you should structure the liquidity event transaction, so making it a point to undertake this analysis sooner rather than later is not only important for the post-event era, but also for the structuring of the event.

A capital sufficiency analysis will also position you to work more effectively with your advisors. Your investment advisors will be armed with the appropriate information to assist you with your investment policy statement, which will inform the process of asset allocation to produce sufficient returns to meet your
core lifestyle capital needs. Your estate planning professionals will feel more confident in providing you with appropriate advice on how to effectively and tax-efficiently move assets inter-generationally or to your charitable causes without jeopardizing your current and future lifestyle needs. Your entire team will be better positioned to structure your overall financial plan to minimize income, gift and estate taxes as a result of thoughtfully considering your capital needs and planning for the future.
There are many decisions to consider prior to the consummation of the transaction. As indicated throughout this discussion, failure to thoughtfully evaluate and plan well in advance may result in unwanted tax surprises as well as insufficient liquidity to provide for your core lifestyle capital needs going forward. Plan early to:

### 1 APPOINT A QUARTERBACK

Appoint a leader to manage your advisory team and ensure integration of strategies

- Manage your personal financial situation with the same coordinated effort as your company’s transaction/deal team
- Develop a comprehensive plan for your investment capital in advance of the transaction
  - *Choice of custodian is critical* — Who will hold your assets? Who will facilitate stock sales?
  - *Short-term strategy* — How will you park your sales proceeds for the short-intermediate term? Note, a portion of the sales proceeds will need to be set aside in secure short-term investments earmarked for the payment of income taxes associated with the liquidity event.
  - *Long-term strategy* — How will you position your portfolio for the long run?

### 2 ARM AND INFORM YOUR DECISION-MAKING

It’s helpful to consider outcomes under a number of scenarios

- Seek to envision your financial situation after the transaction
- Perform a “dry run analysis” of the net, after-tax proceeds and/or value you will receive from the transaction
- Determine your “core lifestyle capital” to inform your ability to pursue other endeavors beyond protecting your highest order goals
- Don’t wait too long — even better, always be ready; time can close the gap on material planning opportunities
A material liquidity event will no doubt provide you with a sense of success and accomplishment. Yet, the shift to wealth owner doesn’t alleviate the need to manage one’s wealth like a business. The following are recommendations and considerations to bear in mind after the transaction:

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<th><strong>KEY TAKEAWAYS AFTER THE TRANSACTION</strong></th>
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<tr>
<td><strong>1 BREATHE</strong></td>
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<td>Breathe, and don’t feel the need to rush into any strategies until you have sufficient time to evaluate them. You will likely be inundated with service providers pushing you to invest your sales proceeds.</td>
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<td><strong>2 WATCH YOUR BURN RATE</strong></td>
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<td>Understand your net cash flow after all taxes and all associated expenses — i.e., know your burn rate relative to your core lifestyle capital.</td>
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<td>• Monitor your expenses via monthly/quarterly financial statements — know your sources and uses of cash.</td>
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<td><strong>3 CONTROL LEVERAGE</strong></td>
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<td>Understand the concept of liquidity versus net worth.</td>
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<tr>
<td>• Don’t become asset rich and cash poor</td>
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<td><strong>4 UNDERSTAND THE CARRY</strong></td>
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<tr>
<td>Understand the erosive power of carrying costs.</td>
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<td>• Real estate is the number-one trouble spot — debt service, utilities, real estate taxes, maintenance, staff costs, repairs — the numbers add up.</td>
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<tr>
<td><strong>5 COMPLY WITH THE TAX AUTHORITIES</strong></td>
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<tr>
<td>File and pay your taxes and seek seasoned expertise to navigate the rules.</td>
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<tr>
<td><strong>6 BUY AN UMBRELLA FOR THE RAINY DAY</strong></td>
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<tr>
<td>No matter how wealthy you become, plan for contingencies. Maintain a sizable liquidity reserve fund to weather the market cycle storms that will inevitably occur.</td>
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<tr>
<td><strong>7 HIRE AN OBJECTIVE ADVISOR AND CENTRAL POINT OF CONTACT</strong></td>
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<tr>
<td>Identify an independent, objective advisor, but don’t check out — meet regularly and ask questions.</td>
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</table>
CONCLUSION: PLAN EARLY, PLAN EARLY, PLAN EARLY.

The best planning happens when there is sufficient time to analyze the potential ramifications of the event and maximize the financial benefits that can result from the liquidity event. There are many sensitive decisions that must be made before signing a definitive agreement (tax elections, valuations, asset transfers), and having a sufficient runway to consider those decisions will be critical to obtain the anticipated tax treatment and financial benefits.

Be sure to understand your current financial situation first and foremost. Knowing your current situation will drive many of your decisions — whether to sell or hold, what price you need, how the transaction should be structured, and what the timing should be. Undertake a capital sufficiency analysis to serve as a backdrop on the many decisions that will need to be made as a result of this transaction.

Finally, be sure that you have a good team in place to advise you on all aspects of the transaction pre- and post- liquidity, and not just on the deal structure. A good team will have your attorney, accountant, financial advisor, investment banker, investment advisor and someone designated as a quarterback to liaise with the team. Working with advisors who are dedicated to advocating for your best interests by providing you with objective and integrated advice is the best way to achieve your financial, tax, estate and philanthropic objectives.
FOR MORE INFORMATION

As a premier financial firm, Northern Trust specializes in Goals Driven Wealth Management backed by innovative technology and a strong fiduciary heritage. Our Wealth Planning Advisory Services team leverages our collective experience to provide financial planning, family education and governance, philanthropic advisory services, business owner services, tax strategy and wealth transfer services to our clients. It is our privilege to put our expertise and resources to work for you.

If you would like to learn more about these and other services offered by Northern Trust, contact a Northern Trust professional at a location near you or visit us at northerntrust.com.