



ADVISOR UPDATE | May 2011

Business Liquidity for the Exiting Business Owner

Consider the many calls on liquidity that a privately owned business faces when the owner leaves the scene. The typical business will experience increased needs for cash at a time when the actual inflow of cash may decrease.

- Business operations may temporarily slow down because customers feel uncomfortable with the business now that the owner is gone.
- Debt may be called; taxes (for example, estate tax) may be payable.
- Transferring business interests takes time and attention that might otherwise be directed at the business's ongoing operations.

Recognizing that these calls on liquidity are common for companies where the owner has departed, it makes sense to anticipate these needs and determine a funding plan in advance. The plan must not only be created for a date-specific event, for example the owner retiring in 2014, but also for contingencies the company cannot control, for example death, disability, divorce and disillusionment.

With enough planning, there are many ways a company can finance the liquidity needs generated by the owner's departure. Some of the following techniques are commonly used by businesses.

1. FUNDING FROM CASH FLOW AND PROFITS OF THE BUSINESS

A profitable business may plan to use cash reserves and ongoing revenue to fund the additional needs generated by the departure of the owner.

Advantage

- If the owner's affect on day-to-day business is not significant, this may suffice.
- Does not require pre-funding.

Disadvantages

- In economic downturns, there may insufficient revenue to cover costs.

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- It's difficult to anticipate the exact amount needed, and being wrong could devastate the business.

2. SELL THE BUSINESS

Determining a plan to sell the business owner's interest is a way to minimize disruption and conflict.

Advantages

- Helps pre-determine the amount needed for the buyout.
- Offers peace of mind to stakeholders such as customers, employees and family.

Disadvantages

- When the sale is to take place, the buyers may not have funding for the purchase.
- The buy-out agreement may limit strategic opportunities for the business in the future.

3. BORROW WHEN THE OWNER EXITS

A successful business may be sufficiently creditworthy to borrow additional cash at the owner's departure.

Advantages

- Avoids tying up capital.
- Offers flexibility to determine loan needs at the liquidity event.

Disadvantages

- Lending sources may not be available at the time of the owner's exit.
- Rates and terms may be unfavorable to the company.

4. BORROW FROM THE GOVERNMENT

IRC Section 6166 provides that certain estates with substantial business ownership can borrow estate taxes from the government at favorable rates.

Advantages

- This is a statutorily offered loan. If you qualify, you are entitled to the loan.
- The lender is presumably creditworthy.

Disadvantages

- Qualifying requirements are specific as to percentage of the business to the estate value.
- The loan is only for the estate tax.

5. BORROW NOW (“Recapitalization”)

The owner borrows money now, takes a distribution, and sells the leveraged business to a child or current management. The sale may be of non-voting stock if control is an issue.

Advantages

- Get cash now and exit later.
- Prefund part of the owner’s exit.

Disadvantages

- There are fewer available sources for such lending than before the recession.
- The debt service on such loans is typically variable, so the costs may increase in the future.

6. CAPITAL MARKETS

A private company can look to venture capital, hedge funds, private equity and other entities that may provide capital.

Advantages

- These arrangements are unique to the business and can often mix equity and debt financing.
- They are a source of capital beyond traditional bank lending.

Disadvantages

- Minimum sizes for these transactions often are \$10 million fair market value and up.
- The owner typically gives up a lot of control over the business and its direction.

7. ESOP

An owner can establish an Employee Stock Ownership plan which is a qualified plan that is funded with company stock. Different from other qualified plans, the company can borrow to finance the plan.

Advantages

- The potential tax advantages are many (possible exclusion gain on sale by the owner, deductibility of principal and interest and income tax exclusion for ESOP earnings).
- Provides a market for the owner and a motivation for employees to succeed.

Disadvantages

- Establishing and maintaining a plan can be expensive.
- To make the plan viable, the company needs to meet certain minimums in income, number of employees, etc.

8. LIFE INSURANCE

Life insurance can provide liquidity to the business exactly when the business needs it. Through the payment of premiums, it defines and pre-funds the obligation

Advantages

- Flexibility in determining the amount of coverage, payment of premiums and exit events to be covered.
- Cash-value products can help provide tax-favored funding for death, disability and retirement events where cash is needed.

Disadvantages

- The insured must be insurable.



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