# The Hidden Costs of Passive Wealth Planning

*Brian Bergsagel*

*Planning for after-tax proceeds and a post-transaction life.*

There is a tremendous amount of work that goes into closing an M&A transaction. The effort necessary from sellers and their team of advisors fosters an intense singular focus on reaching the finish line. When that point is reached, there are usually feelings of accomplishment, excitement, and relief. In some cases, those feelings may quickly turn into uncertainty and a wondering of "What happens now?"

We can recall too many stories of transactions with great valuations but poor tax structuring and post-closing wealth planning that turned what was thought to be a lot of money into far less. During the transaction negotiations, we are often aggressively pushing for an additional two or three percent of purchase price. Yet, without the proper wealth planning, business owners can see a multiple of that dollar amount evaporate through excess tax obligations or a poor post-closing wealth strategy.

One unfortunate case study involves a multi-generation family business client of ours. A few years before the transaction, the founder of the business had transferred the ownership to each of his three children in equal parts. With a premium valuation, the transaction resulted in a mid-eight figure liquidity event for each of the children. Being fully grown and with no involvement in the business, each child followed a very different path from that point forward.

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The oldest took his proceeds and gambled a large chunk of it away, spending the rest on an elaborate house which he ran out of money to finish and sold as an incomplete project for a fraction of the cost. The second oldest invested most of his share in new business ideas and startups that his friends pitched to him, wiping out nearly all of the cash within ten years. The youngest took his funds and, with the help of his wealth advisor, invested them in more stable investments while using a small portion to acquire a business. That youngest child continues to passively grow his wealth while his older siblings look on with envy.

In another example, one of our clients was owned equally by several founding families. When the business was sold, families each took their share of the proceeds and went their separate ways. For one family, the shares were owned by an elderly and unhealthy family member who did not have any estate or wealth planning done in advance. Within months of closing, she passed away unexpectedly and the sale proceeds were incorrectly distributed to her children. Nine months after they had spent most of the funds, the children were surprised to owe estate taxes they could no longer afford. Those estate taxes could have been mitigated by setting up appropriate trust and gifting structures ahead of the sale. The incremental tax liability equated to millions of dollars for her children.

We don't offer these stories as a scare tactic, but many people are not equipped, either with the skill, knowledge or discipline, to prudently manage an overnight abundance of money. These are just a few examples of how extravagant spending, poor investment decisions, or a lack of pre-planning can quickly diminish a pool of capital that otherwise could have lasted in perpetuity.

As is a theme in many of our previous articles, planning ahead is paramount. By working with a wealth advisor that specializes in guiding private business owners through and after a liquidity event, owners can not only optimize their after-tax proceeds in a transaction, they can preserve that wealth far into the future for years or generations to come.

For example, there may be benefits to modifying the corporate structure, transferring ownership to other generations, creating trusts, or even incorporating in a different state. As an owner gets closer to a transaction, the flexibility to optimize some of those factors decreases.

This is where a lot of readers will turn off because in their mind "this applies to someone else." Many clients have told us forcefully they already have someone to "manage their money," and we have had to tell them that is not what we are talking about.

We like to think of it like healthcare. Your primary care physician might have served you well for decades. Everyone needs a solid, consistent general practitioner. But when you need heart surgery, you need the specialist that focuses exclusively on that procedure. You certainly want your primary care doctor to be part of the conversation, but you would not look to them to perform the surgery. Bringing it back to wealth management, a business owner's existing money manager should be involved in the planning discussions but may need to be supplemented with a wealth advisory team that focuses specifically on large liquidity events for private business owners.

## Maximizing Proceeds

In the world of M&A, people love to talk about headline valuations and EBITDA multiples. Those are easy and often exciting numbers to discuss. But what truly matters to an owner are the after-tax proceeds and what those proceeds allow the owner to do.

Transaction structures come in all shapes and sizes and depend on the organizational structure of the selling and acquiring entities as well as each party's post-closing objectives. As a seller, there are strategies that can be used to mitigate taxes through effective structuring of the deal. In collaboration with a tax advisor, attorney, and investment banker, an experienced wealth advisor will be able to analyze different structures to determine the most optimal choice. For example, there may be benefits to modifying the corporate structure, transferring ownership to other generations, creating trusts, or even incorporating in a different state. As an owner gets closer to a transaction, the flexibility to optimize some of those factors decreases.

For business owners living in states with state-level capital gains taxes, such as Washington State, structuring and pre-planning become even more important. Following the budget package signed into law earlier this year, the state capital gains rate now tops out at 9.9% in addition to the 20% federal rate and the 3.8% Net Investment Income or "ObamaCare" tax. Exploring strategies to mitigate or eliminate these taxes should be given as much or more attention as negotiating for an incremental increase in the transaction purchase price.

## Who Can Help You Plan?

The strategies to mitigate taxes and preserve wealth can be complex, and should be fully explained and understood before an owner proceeds down any path. While we are familiar enough with the issues to be dangerous, we of course do not provide tax planning, estate planning, or investment advice. Some strategies include early family gifting, generational skipping trusts, irrevocable trusts, qualified small business stock exemptions, charitable remainder trusts, donor advised funds, and more. The breadth of options requires a good wealth advisor that has the ability to assess the situation and develop a unique solution to solve the problem at hand.

Along those lines, our belief is that the most important attributes to evaluate when deciding on a wealth advisor are customization and approach. Your advisor should be able to take the time to deeply understand your personal objectives and craft a plan that aligns with those rather than applying the same blueprint they use with all of their clients.

You of course need to also trust them and get along with them, as you will be working together on some very personal and important decisions. As mentioned earlier, many business owners already have a wealth advisor or "money manager" in place that helps them make investment decisions.

That person or firm may be capable of handling the comprehensive planning around an M&A event, but it should not be assumed that because they handle investments, they have the comprehensive planning capability that is needed.

There is one approach that we see utilized all too often that can be a barrier to success. This approach, which we refer to as "Seller Math", works backwards from how much a business owner wants to make/spend in retirement to arrive at what they need from the sale of their business. We wrote in detail over two decades ago about the pitfalls of this approach. To summarize, the market value of a business has nothing to do with the owner's post-transaction earning objectives.

The Seller Math approach ignores the real risk of having one's wealth dependent on the success or failure of a single operating business. Avoiding a sale because it doesn't generate the desired lifestyle could be a bad and dangerous decision, becoming a roadblock to achieving both financial and non-financial goals.

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A more productive overall approach is to start from the beginning with an evaluation of the business' fair market value. From there, an advisor can work with an owner to optimize the transaction structure around after-tax proceeds and prioritize financial objectives.

At the end of the day, it may result in a lifestyle adjustment for an owner who was using the business to fund their day-to-day living expenses. The right advisor will be able to work with an owner to prioritize and fund the financial goals that are most important to them, whether that be spending, saving, investing, gifting, or another use of funds.

## When to Plan?

The earlier an owner begins to evaluate these tools and work on their plan, the greater flexibility they will have to utilize each tool. Specifically, most flexibility is lost once an owner receives a bona fide offer for the business, such as a Letter of Intent. Once the fair market valuation is agreed between buyer and seller, the seller no longer has the ability to move things around in a tax optimized manner.

Age and wealth also play a factor. As an owner gets older or is looking at a significant liquidity event, pre-transaction planning becomes more and more beneficial. A rule of thumb that we often refer to is the 50/50 rule: if an owner is over 50 years old or expects to receive more than $50 million in sale proceeds, there are dramatic savings to be gained from thorough advance planning.

Most wealth advisors will tell you that you should be engaging with them several years ahead of a sale, and that is absolutely true. At the very least they should be brought in when a seller is assembling their full M&A team. Delayed planning can cost an owner millions, and the right wealth advisor is worth their weight in tax-free gold.

ZacharyScott.

1200 Fifth Avenue, Suite 1500 Seattle, WA 98101

o: 206.224.7380

zacharyscott.com