By Daniel M. Isard

Key People Succession

Selling your business to a key person is one option. A look at the preparation involved.

Dear Dan,
I have three children. Unfortunately, all of them have pursued careers other than funeral service. I tried everything to bring them into the business – they went out on removals when they were teenagers and were exposed to the prep room; I offered to pay for their education and even offered a Corvette Stingray to any who went to mortuary school! Nothing worked. (I can tell you… I remember when my father got me my 1967 cherry-red Corvette. I was the hit of the incoming class at CCMS).

Now I am getting ready to retire. I have a great key person working in the business who has expressed interest in service to families and the business side as well. Unfortunately, she is poor as a church mouse.

Surely I can't be the only one in this predicament. Is my only option selling to a competitor or one of the consolidators? Every time I'm driving and see a Stingray pass, I'm reminded that it's not my funeral director kid driving it.
Stingray for Succession in Spencerville

Dear SSS,
You are not the only one in this dilemma and a solution is achievable. The key person can be your successor. We just need a little time for planning.

Assume you'll retire in three years. We can create a plan whereby the key person buys some shares for each of the next two years. Then, at the end of the third year, she buys the balance of the shares. Voilà! You are now free to search for and refurbish your old Chevy in your retirement years.

With this approach, the financing for the balance of the shares will probably come from a bank, using Small Business Administration money. The SBA has rules to its underwriting. If the borrower has a 20% interest in the company, there are no restrictions on the financing of the remaining 80%, so our goal is to get the key person to 20% before the purchase of the 80% balance.

Now, you might be thinking that I didn't read your letter clearly. You said, "She is as poor as a church mouse." Keep in mind that I didn't say she will buy these incremental shares for cash. She can buy them using a note. You can finance these shares for her.

Now, before you start shaking your head, hear me out. As an example, let's say your company is worth $1 million. If you have 1,000 shares, each share is worth $1,000. If we are going to try to sell 20% over two years (and then sell the remaining 80% at year three), a 10% interest is worth $100,000. However, it's probably not worth that amount since no one wants to buy a 10% interest in a closely held company.

Being a minority shareholder means you have no control over operations, distributions, direction, hiring or firing. The IRS recognizes that a minority position in a company could be discounted by as much as 25% to 50%. The higher discount might apply in this case because this person is buying a "super-minority" ownership. Therefore, you would sell the first two blocks of 10% each for about $5,000.

That computation doesn't help the fact the key person is broke, so you sell them for a note. The note is paid off via distributions from your company to the key person. These distributions can be dividends if your company is a C corporation or as a prorate pass-through if the company is a Sub Chapter S corporation, LLC or partnership.

Assume the company has earnings of $100,000. The key person would be entitled to 10% of that, or $10,000. She could pay off the note easily. You would get her payment and it will be taxed as long-term capital gains; the tax is almost half of what the ordinary income tax would be if you didn't sell to the key person.

The taxation to the key person is also favorable under 2018 tax law. As pass-through income, it will probably qualify as Qualified Business Income. As such, 20% of the income will be tax free! Thus, the key person gets $10,000 and only $8,000 is taxable. After paying the income tax on the QBI-qualified pass-through, she will have more than the $5,000 she owes you. You could even charge reasonable interest on the note.

Looking at this scenario, you might say, "The key person is getting a $10,000 discount." Yes, she is, for the short term. If we apply a minority discount on the first two blocks, what do you think we would apply on the 80% block you sell in the third year? The inverse of a minority discount is a majority premium. We can assert a small premium (equal to the minority discount) on the final purchase! Even if you don't do the premium, the $10,000 discount to the key person is cheaper than a Corvette with a cherry-red paint job from Earl Shibe!

One of the greater benefits to you, Triple S, is that this is going to be a stock sale. Stock sales generally have less tax for the seller. By selling the shares, you will not need to liquidate the corporation, which usually has tax consequences. Buyers don't like stock sales for two reasons. First, they don't get a new depreciation basis. This is the cost the key person will pay for getting a 100% leveraged business purchase. Second, the chance of liabilities carries over from your period of ownership to the new owner. This can be handled by keeping insurance coverage in place and inserting some legal language allowing for claims against the seller for anything (such as taxes) not covered by insurance.

Making this happen requires some planning. It is easiest if your business is run as an S corporation or LLC. There is some documentation you'll want to have in place:

• *Buy-Sell Agreement* is drawn between the parties memorializing the agreement on the incremental purchases and the final purchase. This will also spell out the actions if one party dies before the final purchase. The buy-sell agreement also spells out how the valuation is handled in the second and third year.

• *Employment Agreement* spells out compensation and perquisites and enunciates the promise of each party to the business not to compete for some period of time. The non-compete agreement would be the same for successor and seller.

• *Notes* should be drafted to be executed for the first two blocks of stock, showing the interest rate and repayment method.

When the key person applies to a lender for the 80%, it will probably be in the form of an SBA-backed loan. This is because funeral service values include goodwill. Local banks are usually conventional lenders; they loan subject to the appraised value of tangible assets. They don't make loans on the value of goodwill. The applicant should have a good credit score. If that is impaired now, she has two years to clean it up.

A qualified appraiser with experience appraising funeral homes (this is key) is needed to make sure the valuation of the business and real property is correct. Both buyer and seller have a vested interest in making sure the value is right, not prejudicial to their respective sole interest.

The best test of the conclusion of value is confirming that the business can afford the debt with a reasonable margin of error. If principle and interest on the 80% note is $1, company earnings should be at least $1.35. This is the debt coverage ratio test. The borrower should keep in mind that principal on the note is not deductible, so she will need to have excess cash flow to pay taxes on the principal.

Selling to a key person is one option. There's nothing wrong with selling to a regional competitor or national consolidator, and you can negotiate a good employment agreement for the key person. Funeral service is going through a contraction in number of locations. Your objective is to monetize your investment. There is also no stigma to selling a family business. However, no national consolidator I've ever seen uses a Corvette as a removal vehicle!

Dan Isard, MSFS, is president of The Foresight Companies, a Phoenix-based business and management consulting firm specializing in mergers and acquisitions, valuations, accounting, financing and consumer surveys. He can be reached at 800-426-0165 or danisard@theforesightcompanies.com. For copies of this article and other educational information, visit theforesightcompanies.com.

Financial and tax advice contained in this article is for informational purposes only and may or may not apply to your individual position. Readers are strongly encouraged to seek the counsel of qualified advisors before undertaking any action based on this information.