THE HOUSEHOLD ENDOWMENT MODEL®

Why Every Business Owner Should Have an Exit Strategy

The following is adapted from The Household Endowment Model.

People generally build businesses for three reasons. Firstly, they want to provide a good lifestyle for themselves and their families, and secondly, they don't want to work for someone else. The third goal is to build a business for eventual sale at considerable profit or to hand over to future generations.

If you're a business owner, it's likely that your attention is sharply focused on running and growing the enterprise. That doesn't leave a lot of bandwidth for thinking about that third piece. Many of my clients are independent professionals in their forties or fifties. They're relatively young and not thinking about how they're going to sell and get out of their businesses. An exit strategy may never cross their minds, but it should.

Actually, they should be thinking about an exit from day one. Even if you plan to be at the helm for a long, long time, you should immediately start considering how and when you will leave. It may sound counterintuitive, but keeping your eye on the door will help you build a stronger, more profitable, and longer-lasting business. Here's why.

Shifting Your Assets Helps You Protect Them

As your business becomes more successful, you need to pay attention to the details of both your personal net worth and the business's value. Business owners usually hold most of their assets in their enterprises. That may be necessary when first starting a business, but this approach becomes increasingly self-defeating as the business grows.

The key to planning an exit strategy is separating your business and personal assets while gradually transferring as many assets as possible from the business to the personal column.

Let's use a simple analogy. If you're a business owner, think of your financial life as being like a pair of pants. Say your business assets are in the front left pocket and your personal or individual assets in the front right pocket. There are two pockets but one pair of pants: all your assets are in one pocket or the other.

The basic principle is, whenever possible, to move assets from the front left to the front right pocket—from the business to the personal side. Of course, it's a bit more complicated than that. You may need to move some assets to a side or back pocket, depending on which strategies, such as tax mitigation, are used to protect your personal wealth.

The simple rule is not to put all your assets in one pocket. If all your wealth is tied up in your business, and something happens to it, there goes all your wealth. With all investments, including your own business, you need to diversify. As a business owner, you need to begin taking some of the wealth and assets invested in the business and put it into other investments as soon as possible. Doing so will give you greater long-term security.

These are all different pockets in the same pair of pants. The money isn't being taken away but getting moved around so that you can keep as much of the profits you make as possible when selling your business. If you keep all your assets in your front left pocket, you may have to pay up to half your profits in tax when selling your business, and that's obviously what you want to avoid.

It's worth noting that moving assets from the operating business "pocket," where they are liabilities, to the personal "pocket," where they are protected, will also help preserve your assets in the shorter term. This also means that, while it's never too late to start exit planning, it's always better to start early.

The Benefits of Starting Early

You can't wait until the day before you decide to sell to say, "Okay, I'm going to sell my business tomorrow." If you don't want to give up a large percentage of your profit to taxes, you have to plan for the sale years in advance. Selling your business requires preparing and executing an intricate transition process.

Part of that is diversifying and shifting your assets, but another big part of your exit strategy is thinking about how you will structure the business so that you can eventually hand it on in the best possible shape.

Do you want to sell your business, making it your retirement plan? Do you want to turn it over to the next generation? If so, are there members of the next generation with both the desire and ability to take it over? Knowing the answers to these questions well in advance of an exit can ensure that your business remains as profitable as possible, because you will be able to take advantage of valuable wealth management tools.

For example, a Deferred Sales Trust (DST) is an important tax-deferment tool that is useful for planning and executing a business exit. The proceeds from a sale can be put in a DST, which has several advantages, beginning with tax deferment. In a recent case, a business owner who had just sold his business would have had to pay $600,000 in income tax if the profits from the sale had not been put in a DST.

A DST doesn't eliminate this tax, but, because it defers it, that $600,000 can now be invested, along with the former business owner's other assets. Taxes can be deferred, and return from the investment realized, for any number of years. In some cases, tax can even be eliminated if the trust remains in place after the owner's death, since the assets in the trust will then pass on to the business owner's beneficiaries.

Another tool is utilizing the tax advantages of hiring your own children. You can pay them through your company payroll, and they can then invest that money in an IRA. That means you can write off what you paid them, and they can write off what they put into their IRAs. Taxes are significantly deferred or eliminated, creating another way for you to pass money from your business to your children. If you plan early, you'll have less to worry about later.

One Foot Out the Door

Bear in mind that your exit strategy will keep changing and evolving. Times change, tax laws change, and the economic environment changes. The earlier you begin planning your exit strategy, the more it may change over time, and this should be seen as a net positive, since it increases your level of control.

Typically, when someone isn't fully committed, people say that they have "one foot out the door," but in the case of owning a business, an exit plan is a surefire sign of full commitment. Having an exit strategy in place and diversifying your assets through the years will protect you as a business owner and make sure that you're maximizing your returns on your diligence and ambition.

For more advice on business ownership, you can find The Household Endowment Model on Amazon.

Vince Annable, CRPC®, is the creator of The Household Endowment Model® and founder and CEO of Wealth Strategies Advisory Group. Vince has been involved in the financial services industry since 1981. Vince prides himself in bringing new investment methods to high net worth families. He's had families approach him after learning his method to tell him that they didn't understand why their own advisors hadn't told them about it. He's also taken his message to the public on The Michael Wall Show, ABC15 Sonoran Living, and as the host of the podcast, Your Money Manual.