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Parental Financial Security Trumps All

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For most owners, the business is the primary source of wealth and income. If this is true for you, you should have all of the desired cash in the bank before you transfer control and ownership.

Financial security comes in three basic varieties: those who have it; those who know how to secure it; and those who have the means to obtain it.

- Those who have financial security can afford to receive less than full fair market value for their businesses. They have typically attained financial security by investing excess earning outside the business during their active years.
- Those who know how to secure financial security commonly purchase assets outside of the business, and lease those assets back to the business for use. Assets purchased for lease typically consist of office, warehouse/manufacturing facilities, or equipment used by the business. Keeping these types of assets outside the business lowers the value of the business, thus easing its transfer to the active child by incurring less transfer (gift or estate) taxes. Keeping assets outside of the business also makes those assets (or wealth) available for transfer to the inactive children. Finally, keeping assets outside the business protects them from future creditors of the business after the parent has left.
- Those who possess the means to achieve financial security are able to sell their businesses *for cash* to the business-active child. *A business owner should not consider, even for a moment, transferring control, either operational or ownership, before financial security has been achieved.* If an owner wishes to leave the business before accumulating enough wealth to be provided with sufficient independence, then it is incumbent upon the business-active child to obtain financing in order to pay sufficient cash for the ownership interest.

As a business owner, you must determine which flavor of financial security suits your palate. Keep in mind that even if your financial security does not depend on receiving full market value for your business, you must either insist upon it or accept the fact that by accepting less you are giving away at least a part of the business. Once you start giving things away the fairness issue crops up. If you don't handle these fairness issues through your estate planning documents, your recipe has become, at best, unpalatable to the children.

Some of you may have noticed our definitions of financial security did not include selling a business, over time, for little or no cash to the business-active child. Although this course of action is all too common, it is fraught with peril and usually doomed to failure. At the outset of this article, we established that we would provide only successful recipes; hence, the omission.

Finally, those parents who sell the business for cash to the business-active child must begin the transfer process before they begin retiring. Under the best of circumstances, the modified cash method requires that the "pump be primed." A child must receive significant ownership before acquiring the balance of the company for cash. If the transfer is to occur over an extended period of time, it is vital that parents retain ultimate control as well as subject the stock transferred to the child to a buy-back agreement should the child leave for any reason. Also, in this agreement the parent will want to be obligated to repurchase any interest from a business-active child so that, if he or she chooses not to complete the buy-in process, you can execute your back-up plan.