

BUSINESS SUCCESSION PLANNING

A vast number of business owners spend years, if not decades, building, growing and developing their business. Thus, it is not unreasonable to assume that under most circumstances the small business is the owner. The owner alone makes key decisions, deals with major customers or interacts with important suppliers. However, as the business owner nears retirement s/he is faced with a number of difficult questions: who will control/operate the business as the current owner enters a new phase of his/her life? Will this responsibility be entrusted to an heir or will it be outsourced to a professional manager? If the former, how does one choose among the various heirs? Lastly, and perhaps most importantly, how can the business owner maintain financial security throughout this important transition? Needless to say, answering these can be quite overwhelming for a large number of small business owners. As a result, business succession planning is too often banished to the back of the mind to the detriment of the business owner, the business entity as well as successive generations.

What is "business succession planning"?

Briefly, business succession planning ("BSP") is the orderly process through which control of a closely-held business is passed to others. As the family business represents a highly undiversified investment, the primary goal is to transfer ownership of this unique asset, in the most tax-advantageous manner, while maintaining personal financial security. In effect, BSP is an overlap between estate planning and business planning. When these matters are handled by two sets of lawyers who do not communicate with each other the result may be confusion through lack of coordination, severe tax consequences and the creation of conflicts between family members and/or unrelated co-owners.

How does one begin the process of business succession planning?

Ordinarily, BSP begins by fleshing out the business owner's desires and objectives. This is usually done by getting the business owner to answer a few basic questions including:

- Where does the business owner see himself in 5-10 years? In the office? Deep-sea fishing off Cabo San Lucas?

- What characteristics make the business a success? Is the business on the upswing or downswing (e.g. CD stores, video game arcades)?
- What is the business worth now and what is it worth without the particular owner?
 - What are the objectives for the owner, family and employees?
 - -In the future, what role will the business owner have in the business?
 - -Is the business owner emotionally ready to turn over operational control to another generation?
 - -Does the owner view employment of family members in the business as a right or a privilege?
- What are the current and future sources of income for the business owner and spouse?
- How is cash being currently drawn out of the business: salary v. dividend?
- Who will control the day-to-day operations of the business? What are their strengths and weaknesses?
- How will the non-active family members receive income from the business? Will this create a conflict with active family members who want to see income being reinvested?
- Which roles will be filled by outsiders?
- Who will have an ownership interest in the business?
- Will equal treatment of family members have a detrimental effect on the well-being of the business?
- Etc.

Tips for effective business succession planning

1) Start early. A sudden loss of leadership can have profound repercussions. Furthermore, much like estate planning, BSP is a process, not a single event. The earlier one starts planning the more effective the transition (from a business as well as a tax point of view). For example, tax-benefits of strategies such as the formation of family limited partnerships are severely reduced if engaged in late in the business owner's life.

2) Coordinate estate planning documents with business succession documents. For example, does the buy/ sell agreement permit the funding of a QTIP trust for the benefit of a surviving spouse? Does the buy/ sell agreement prohibit lifetime or testamentary gifts to descendants?

3) Provide cash flow to the surviving spouse. If the business owner has been taking

income from the business in the form of compensation, will the surviving spouse be entitled to income when the business owner dies? How will the earnings of the business reach the surviving spouse? How can the business owner make be assured that stock will be voted in favor of a dividend?

4) Insure the buy/sell agreement. An "insured buy/sell agreement" is a buy-sell agreement under which the purchase obligation at the death or disability of an owner is funded, wholly or partially, by an insurance contract insuring the business owner. The insurance policy is owned by and payable to the purchaser - whether the entity or remaining co-owners - thereby providing liquidity in the event of death or disability.

5) Don't ignore family dynamics/harmony. Consider whether family members who are inexperienced or unemployable in the outside world should be given executive positions or whether non-voting interests are a better alternative. Sometimes "fairness" is superior to "equality".

Business succession planning is a topic of growing importance

In the summer of 2007, Massachusetts Mutual Life Insurance Company underwrote the 7th in a series of surveys monitoring trends in family business since 1993. In October 2007, the results of the 2007 American Family Business Survey were released to the public. Here are some interesting statistics:

- Within 10 years, 40.3% of business owners expect to retire;
- -Of these, 45.5% of those expecting to retire in 5 years have selected a successor;
- -29% of those expecting to retire between 6 and 11 years have selected a successor;
- 31.4% of business owners have no estate plan beyond a will. Furthermore, only 53.5% have a good understanding of estate taxes that could be due upon their death. The lack of a good understanding of wealth transfer taxes usually brings about an excessive tax burden to heirs and, as a consequence, the business' failure.

Furthermore, a survey conducted by Laird Norton Tyee, a Seattle-based wealth management firm, uncovered the following statistics:

- Nearly 60% of majority shareholders in family businesses are 55 years or older.
- -Nearly 30% are 65 or older.
- Less than 30% of the business owners surveyed have succession plans and fewer than 40% have a successor in line.
- Nearly 64% of respondents don't require that family members have qualifications or related experience, and 25% think that the next generation is not competent to assume leadership roles.
- 93% have little or no income diversification. That is, if the business fails upon transfer, very little is passed on to the inactive spouse or next generation.

Succession planning, including selling or gifting business interests, dealing equitably with children, developing management successors, retaining key employees, estate planning for the owner, and contingency planning for the owner's death or disability is a constant topic of discussion. If you own a business and want to preserve the benefits that it has provided for you and ensure that the same benefits continue to

be provided to your family, consider giving BSP some thought.