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THE BASICS OF BUSINESS SUCCESSION PLANNING

Business owners are busy. Starting, running, and growing a business takes time, and normally carries the business owner well outside of the bounds of a normal 9 to 5 business day. It should therefore come as no surprise that most business owners have no succession plan.

WHAT IS A BUSINESS SUCCESSION PLAN?

Business succession planning is the process of deciding how to transfer your business. Ideally, succession would occur at the business owners retirement, but thought should also be given to what would happen if the owner dies or becomes disabled.

There are many pieces to a good business succession plan, but a good starting point is to consider: 1) who will manage the business, and 2) who will own the business. Often the same person would both own and manage the business, but that is not always the case.

Example 1: Consider a business with a long time key employee. The employee has worked for the business long enough to learn all aspects of the business, and understands the operation of the business nearly as well as the business owner. That employee might be an ideal buyer when the business owner decides to sell. Alternatively, that key employee might make the business more valuable for a sale to a third party, or allow the business owner to transfer ownership to a child who is not ready to operate the business.

Considering the ownership and management separately is helpful to the process of logically thinking through the available succession options. It is also helpful to putting a plan together for getting and retaining key employees, which should ideally occur long before the actual succession.

TRANSFERRING THE BUSINESS TO A FAMILY MEMBER.

There are many ways to transfer a business. The method used is often dependent on who will receive the business. Deciding whether the recipient of the business will be a family member is often difficult, but must be addressed. The need to decide which family member receives the business can be even more challenging.

Example 2: A business owner has a manufacturing business held in an operating company, and a second company, which owns the building where the business is located. The owner has three children. One of these children has worked at the business for 10 years. The second has worked at the business on and off, but is currently employed elsewhere. The third has never worked at the business, and appears to have no interest in working there.

Give this situation, the business owner might decide that the first child is the logical successor to the business. However, because a business often comprises a large portion of the business owner's assets, it might be difficult to give the business to one child, while treating the other children equally. It might be possible for the first child to purchase all or part of the business, to help with the treatment of the other two children. In these cases, the business owner might need to consider the difference between treating the children equally, and treating them equitably.

Because the owner in this situation has both an operating company and a holding company, the two businesses could be treated differently in the succession plan. The second and third child might own part of the holding company, but little to no interest in the operating company.

Any time multiple children are involved, it is important to consider the relationship between the different parties. For example, if the non-participating children are given an interest, how will that affect the relationship between the three children. In the worst cases, it leads to outright hostility and litigation. Even if the family gets along well, well intentioned differences of opinion can lead to tension between family members.

METHODS OF TRANSFERRING A BUSINESS.

The basic building blocks of transferring a business are a sale or a gift, but how a business is transferred is often driven by circumstances. For example:

> Is there a potential buyer for the business, and what is a realistic price?
> Will the transfer be made to a family member, employee, or a third party?
> Is the business owner reliant on continued income from the business?
> When, and under what circumstances, will the business owner step away from operating the business?
> What will be the fairest treatment for the business owner's children?
> What are the income and estate tax consequences of the proposed plan?

In a sale, the business owner will receive compensation for the business. The compensation might come in a single lump sum payment from the buyer. In that case, the buyer either has the cash required to make the purchase, or receives a loan from a bank or another party to pay the business owner. However, it is also common for a business owner to finance part of the deal by receiving installments from the buyer.

If the purchaser is a family member, the business owner might also consider the option of giving the company to the family member. A lifetime gift of the company is appropriate where the business owner does not need the funds from a sale for retirement. If income is needed, a business owner might instead pass their interest at death using a bequest, which is when a business passes as part of the owner's will or trust.

Income and estate taxes will often be a major factor in the business owner's succession planning. If a business is sold during the business owner's lifetime, the owner normally needs to pay capital gains taxes on the sale. If the business is instead passed in the owner's will, the capital gain can be avoided through a step up in the owner's basis in the company, which basically erases the capital gain.

In larger estates, the business owner also needs to plan to avoid estate tax. There are various techniques that can be used to reduce the estate tax burden of the business owner. This includes strategic gifting, and the use of trusts. If the business owner has a large estate, it is always worth discussing the potential estate tax consequences with their attorneys and tax professionals early on.

THE IMPORTANCE OF A BUY-SELL AGREEMENT.

Even if the business owner is not planning to sell in the near future, it is still important to consider some basic succession planning. Most commonly, that means a buy-sell agreement. A buy-sell agreement is an agreement for how the business will transfer in the case of a triggering event. For example, if the business owner dies, the agreement would give another party, or the company, the right to purchase the business owner's interest. Buy-sell agreements also cover events like disability, disagreements, bankruptcy and divorce. Buy-sell agreements are often overlooked by business owners as they start their business.

Example 3: Two business owners start a business. After five years, the business has become successful, but much of its cash flow is used for growth and debt service. Owner A, who is married, dies unexpectedly and his will leaves all of his property to his wife. Both Owner A's wife and Owner B would prefer not to be business partners, but Owner B does not have the cash flow to purchase her interest.

If the Owners of this business had a well-funded buy-sell agreement, it would benefit everyone. Typically, a buy-sell agreement will provide a method for one owner to purchase the other owner's interest in the case of their death. This benefits the surviving business owner, who did not choose to go into business with Owner A's family. It also benefits Owner A's family, who would have a hard time selling their interest to anyone other than Owner B.

This example helps to show the importance of planning ahead. Succession planning is meant to ensure a smooth transition of the business. Planning ahead helps to ensure that unexpected events do not result in avoidable problems. Further, engaging in succession planning can help to identify steps that can be taken to increase the value of a business prior to a sale. It is typically recommended that a business owner take basic succession planning steps early on. At a minimum, it is important to begin the planning process three to five years prior to an anticipated sale.