Succession Planning for Small Business Owners

I. Challenges associated with Business Succession Planning

Business succession planning requires work done by an attorney, accountant and financial professionals. This planning often involves coordination in the areas of business valuation, taxes, estates, insurance, investments and fringe benefits. Most business owners use multiple advisors. These advisors often do not talk with each other. As a result, ideas from different advisors may contain conflicts that are undiscovered and unresolved – often until it is too late! Conflicts between provisions in business agreements, insurance ownership and beneficiaries, business valuation, and tax strategies can result in costly delays, conflicts, disputes and lost opportunities.

Business profits do not guarantee a successful business succession. Less than 30% of successful closely held businesses transfer to a second owner and 10% transfer to a third owner. Only 26% of closely held businesses have a written succession plan.*

2. Business successions are often triggered by major life events such as:

Death
Disability
Retirement
An owner wants to "walk away" from the business before retirement
"Alienation" of business ownership due to an owner's divorce or bankruptcy

<u>The Keep/Sell/Liquidate Decision</u>: Each of these events require a decision by the owner or survivors to keep ownership of the business, sell the ownership interest or liquidate the business. Since many of these events are unwelcome and some are unexpected, there is a tendency to avoid thinking about them and hope they will not happen. However, potential consequences of poor planning or no planning include: liquidation of the business, excessive tax costs, a poor sale price, family conflict, or large debt burdens for those who try to continue the business. Often business owners delay retirement because they cannot find an acceptable solutions to one or more of the following areas:

3. An effective plan needs to resolve key questions in four areas:

Ownership Transition
Management Change
Family Concerns
Financial Issues

<u>Ownership Transition:</u> Who should own the business interest? How will they get it? (sale, gift or bequest) Will the owner also manage the business? Should ownership rights be outright or be restricted by legal agreements or be owned by a trust? How will business risks and liabilities be handled. What ownership changes be optional versus mandatory? Should the desired changes be addressed in advance with buy/sell agreements, amended wills or living trusts?

<u>Management Changes:</u> Who has the ability to run the business? Will there be any gaps in skills, knowledge or key business relationships after the change? How can they be addressed? Are there key employees who will need to be retained after the ownership and management transition?

<u>Family Concerns</u>: Will the succession be a family member? How does this affect the transaction? How will family members who do not work in the business (spouses and children) be treated? Are there any family concerns that

may interfere with an effective business plan? What will family members see as "fair?" Are there potential disputes? How can they be resolved or avoided? A business owner is unlikely to implement a plan that does not adequately address the business owner's family objectives.

Financial Issues: What is the range of potential values for the business? How does this compare to the financial needs of the owners for retirement income or income for surviving spouses? Will the source of funds if the business is sold be life or disability insurance, installment notes or unknown? Is there a possibility the business will go public or be sold to a large corporation? Should the value of the business be "pegged" in advance? What are the potential estate and income tax liabilities? Are there ways to minimize these tax costs? Is there a desire to "equalize" the estate between heirs who will receive business ownership and those will not? Are the business financials organized to minimize taxes and maximize benefits for current owners or do they clearly demonstrate the value of the business to a potential buyer?

4. **The Business Succession Planning Process**: A disciplined approach to planning is necessary to develop an effective plan that accomplishes the business owner's objectives.

   a. Clear objectives from the client, spouse and any other key people. This may include children and key employees. It is best to identify similarities and differences in objectives early in the process because it is easier to develop creative solutions at that time rather than discovering serious objections on the day everyone else wants to sign documents! Objectives should not be limited to business matters. Clients are unlikely to implement a plan that conflicts with their personal estate and retirement needs and desires. Setting objectives requires skillful questioning and discussion. Since people naturally avoid thinking about death, disability and even major changes such as retirement, the first thing that comes to their minds may not represent their true desires.

   b. Gather and review complete information on the business and personal situation of each person. Accurate information on business structure, financials, history and future plans and essential in valuing the business and evaluating different strategies. Personal assets and insurances are necessary to evaluate estate and retirement objectives. A review of existing business agreements, wills and trusts will establish what would happen today in a succession event.

   c. Identify and document the issues that need to be addressed. Acknowledging and accepting a problem is a necessary step before your client will agree to the disruption and cost of a solution. Do not assume clients will be concerned or even perceive the problem until they confirm their concern.

   d. Design potential solutions. This normally involves considerable "backroom" work and collaboration with other professionals.

   e. Review potential solutions with the clients and discuss which solutions they are willing to implement. Review the financial requirements for the plan and obtain commitment on what the clients are willing to spend. This step may involve both separate and joint meetings with owners and family members before the necessary decisions are made.

   f. Implement the plan. Coordination is essential at this stage which may include tasks such as: drafting legal documents, underwriting insurance products, transferring business interests, changing ownership or beneficiaries of insurance products, IRA's and qualified plans, formal business valuations and filing gift tax returns. This is the "all hands on deck" stage where all advisors need to work effectively as a team.

5. **A Team Approach to Planning**: Business Succession planning is not a solo sport. A team of advisors is necessary to fully develop and implement the plan. Like baseball, each advisor gets a turn "at bat" where their skills, knowledge and expertise are essential. However, at other times the team must work together as a unit in order to get the job

done. Respect, communication and collaboration keep the process moving forward. When communication breaks down among advisors, the client often freezes in place and nothing gets done.

6. Questions and Discussion:

**Source: LIMRA: Affluent Small Business Owners, 2009*