CHAPTER 70

Business Succession Planning

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This chapter is designed to provide a broad overview of the business succession planning process, familiarize you with some of the terminology, and discuss general considerations in the planning process.

Businesses change ownership for a number of reasons, including unexpected health problems, death, divorce, sale, or retirement. Each of these circumstances presents different challenges to successfully plan for business ownership transition, but a proactive approach to the planning will help maximize the proceeds to the seller and the profitability of the company.

Owners of companies valued below $10 million, who wish to transfer their business to family members, unrelated key employees, or outside third parties, should consider one or more of the possibilities discussed in this chapter and beyond to meet their needs and the needs of the business.

In a study by the National Federation of Independent Businesses, 40% of small business owners are age 55 or older[1]. Anecdotally, this means that many businesses will experience a transition in ownership, whether there is a plan to do so or not. Just as studies show that only 30 to 40% of individuals die with a Will in place, many won't engage in this type of business succession planning[2]. However, those who do can not only ease the burden on their family, employees, and their business, they can maximize the amount received for their business interests.

There is little doubt that a substantial number of small businesses will change hands, just as the population "bubble" of the baby boomers continues to age. One can reasonably conclude that, as we are told, there are a large number of individuals who will die in the next 20 or 25 years. Many of these individuals own businesses. Those ownership interests will transfer during this period; some interests will transfer multiple times.

The primary tools for business succession planning are:

- buy-sell agreements;
- stock bonus plans[3];
- deferred compensation plans[4];

- qualified retirement plans, including employee stock ownership plans ("ESOP");
- non-compete agreements;
- consultation contracts; and
- death transfers using wills or will substitutes, such as living trusts.

Each of these tools can be potentially useful, based on the goals and circumstances of the owner and company. These options should be carefully considered and crafted to form a plan that becomes a successful business succession plan.

In order to determine which combination of tools to implement, information must be obtained about the company, its value, employee make-up, the owner's family circumstances, and ultimately the owner's personal objectives.

QUESTIONS FOR THE OWNER

The business owner will make several decisions prior to beginning the planning process, whether he or she is aware of it or not. Such decisions will include: what advisors to hire; what process the owner will pursue; the pricing of these services; and the timing for hiring, paying for, and implementing this type of plan.

We have found that the team employed is critical, and there must be rapport among the team of advisors and the owner. The team typically consists of an insurance/financial advisor, certified public accountant, valuation analyst, and attorney. The team may consist of more than one of any, or several, of the team members listed. It is crucial to have members who understand the various roles and tools at their disposal to implement a plan effectively.

To begin the planning (Business Succession, Exit, Transition Planning, as it is variously known), some questions are in order. The answers to these questions are required in order to begin crafting a plan for the transition of ownership under various circumstances.

- When do you want to exit your business, or how much longer do you want to remain active in your business?
- How much money do you need in order to allow an exit (taking into consideration the impact taxes will have on what you get)?
- Under what terms do you want to transfer the business — payment over time such as an "earn out" (payments contingent on future business performance), or an outright sale receiving a lump sum payment?
- Whom do you want to receive the ownership interest — family member, non-family insider, third-party?
- When are you willing to become committed to the planning process?

Although not discussed as regularly as the foregoing issues, given the focus on the benefit being conferred on the transferee, the current owner must consider which structure gives the company the best chance of being successfully paid for and continuing to prosper as a business.

FAMILY MEMBER TRANSFEREES

Just as those who have a family should engage in estate planning to smooth the transition at death, minimize potential disputes, consider and plan for any federal estate and state inheritance taxes, and provide a clear map of the wishes of the Testator, these issues are magnified when a closely held business interest is part of the estate. Most estate plans involve dispositions of assets to surviving spouses, either outright or in trust for their lifetimes, as compared to the state statutory scheme in some states which have children inheriting a percentage of the estate outright. Without a Will, both a surviving spouse and one or more children may become the new owner or partner with a surviving partner. With a Will, the surviving spouse may be a partner in effect, but the children wouldn't be, unless it was the desired outcome.

A thoughtful plan for business succession incorporates estate planning for the various owners and key employee(s), or children who will run the business after transition. With a business succession plan, the spouse, unrelated key employee, or children can be a part of the company, but it occurs by design, rather than by accident. The plan frequently contemplates several options so that if the spouse and/or family is not to be involved in the business, they receive a predetermined value for the interest and are not burdened with continued involvement in the business.

As is done in estate planning for families involving children from previous marriages and the potential to disinherit one "branch" of the family following the death of the natural parent, equalizing the inheritance of a non-participating child with the inheritance of a child who ends up with some or all of the business interest must be addressed. In many estates that include ownership of a small business, a major portion of the estate's value may be comprised of this business interest.

While ownership may provide adequately or even handsomely for the child who inherits the ownership, it may otherwise mean substantially less value passes to children not involved in the business. Simply leaving the non-active child some ownership in the small business, without a paid position within the company, is often, at best a Pyrrhic victory[5]. Few small companies, as a practical matter, pay dividends to shareholders, nor are they required to in most circumstances.

Of course, the actual transfer can take the form of a bequest at the death of the owner to one or more family members. If the needs of a surviving spouse must be addressed, and the business is the primary asset of the Testator, then a buy-sell agreement between the Testator/Owner and the family member might be implemented. Assuming compensation reasonableness can be maintained, a "stock

bonus" plan that transfers partial interest in given years to the transferee can be implemented during the life of the owner. The effect on the other heirs, who would inherit either a portion of the business interest or an equivalent value, must be considered in this context.

NON-FAMILY TRANSFEREES

What if there are no family members working inside the business? Or, what about situations where there are family members working in the business, but none are interested in taking over the company in the future?

Most likely, the owner will not be inclined to make a gratuitous transfer to non-family members if you exclude bonus type arrangements. Thus, the planning must address transferring the ownership interest over time or at a specific point to the "key" person transferee. If the company is of sufficient profitability and has a large enough eligible payroll, an ESOP may meet the various needs of the owner and company. An ESOP allows tax-advantaged proceeds to the current owner[6] and transfers ownership to management via tax deductible contributions[7].

Various agreements, either alone or in combination, might be used.

- Stock bonus to transfer stock over time to a transferee;
- Buy-sell agreement to transfer stock under predetermined conditions at a "trigger point" in the future, often coupled with life insurance (and/or disability insurance) to provide the funding at the needed time to pay for the interest in the company;
- Non-qualified deferred compensation can be used to "fund" the eventual purchase of the interest without transferring cash or stock today to the potential transferee; and/or a
- Promissory note, with the company assets or stock being used as security for a stream of payments.

VALUATION

It may seem contradictory, but a valuation of the business, commonly called "the lowest supportable value" may be in your and your family's best interests. Why? Because it allows the outright transfer to family members via annual gift tax exclusions or via transfers of limited partnership interests at substantially greater values than might otherwise be thought possible.

A valuation, whether low or high, when selling to an insider is not nearly as important as the cash flow of the "deal" after the owner departs and the buyout begins. The future cash flow of the transaction and lower tax burden are more important. By lowering the tax burden, the cash flow of the business is enhanced, allowing greater access to cash flow to fund the transfer.

TAX CONSIDERATIONS

Estate tax considerations in an owner's estate plan must be considered in light of the current and forecasted value. The transfer of the interest will impact the net amount received by a seller and the total amount earned in order to fund a buyout of the business.

The income tax effects on the net proceeds to the seller must also be considered in structuring the plan. For each increase in payment to the seller, the buyer of the company must earn an even greater amount (before taxes) to fund the payment. Additionally, capital gains treatment to the seller reduces the total needed to meet his or her goals in selling the business.

Under the right circumstances, the benefit to the seller is increased and the burden on the purchaser is reduced if an ESOP or other tax advantaged tool is used. This is because an ESOP permits tax-deductible company contributions to be used to fund the purchase of the stock and potential favorable tax benefits to the seller. Other qualified retirement plans can be useful in transferring funds to the seller in satisfaction of the payment. For example, a qualified retirement plan in which the seller and purchaser are both participants and "highly compensated employees," can be structured to benefit one to the exclusion of the other. Because, these contributions are also, within limits, tax deductible, it reduces the total burden on the company to fund.

BUSINESS SUCCESSION CANDIDATES

Small businesses are categorized in a number of ways, but businesses that engage in this type of planning are generally those with a motivated owner who recognizes the benefits of such planning, and the economics justify implementation of the plan. The "efficient" horizon for this planning depends on the overall value of the business, but the type of business affects this horizon. For example, the feasibility of planning for a service company, which is valued at $1 million may very well be more valuable than a manufacturing company of the same value, due to the additional cash flow of the service business.

Of course, this begs the question, why plan the transfer of ownership of a business?

Are you like many business owners?

- A majority of closely held and family owned businesses will change hands within the next five years[8]; but
- Many business owners may not have taken active steps to transition out of ownership.

Again, if you are like many of business owners, the reasons for failing to plan may be:

- You may have simply been too busy working in your business to be working on it.

- You may be unsure of how to begin succession planning, whom to use, or even where to begin.

Proper knowledge and preparation can possibly mean millions of dollars to you when you ultimately leave your company. If you start succession planning today you can help to avoid the sad (but too common) fate of owners who don't plan — those whose delays cause additional burdens to their families, reduce the amount ultimately received for their business, and may jeopardize the continued success of the business. Your plan will begin to take shape as you answer each of the following questions:

1. What are your retirement goals, and what level of assets will this require?
2. What is your business worth, in cash, today?
3. What options are available, and what is the best way to increase the income generated by the transfer of your ownership interest?
4. What method(s) of transfer will allow for lower taxes when transferring your business to family members, co-owners, or employees, while lowering taxes?
5. Is there a plan for continuity if something happens to you? Does it include your family's needs?

Creating and implementing your succession plan is an important business decision and may be your most important lifetime financial event.

The Windsor Law Firm, PLC uses compensation, tax, and estate planning expertise to assist small businesses meet their succession planning and legacy objectives for employees and family.

1. Volume 5, Issue 3, 2005, William J. Dennis, Jr., NFIB Research Foundation
2. Fifty-seven percent (57%) of Americans do not have a will, according to a 2004 study by Findlaw.com. In a 2004 AARP survey, it is reported that sixty-percent (60%) of those over age 50 have a Will.
3. Used here more generally to refer to any one of a number of stock or equity based plans including: §83(b), stock purchase, Stock Option (including incentive and non-qualified stock option) plans.
4. Those plans involving crediting an amount to an employee participant in such a plan, but the employer receives no deduction until such time as the employee includes the amount in compensation. Until that time the funds remain the asset of the employer, subject to the claims of the employer's creditors.
5. A Pyrrhic Victory is a victory with devastating cost to the victor. A Pyrrhic victory is so called after the Greek king Pyrrhus, who, after suffering heavy losses in defeating the Romans in 279 B.C., said to those sent to congratulate him, "Another such victory over the Romans and we are undone." Source: www.dictionary.com
6. §1042, qualified replacement property, for so called "C" corporation stock, it excludes subchapter "S" stock from this favorable treatment. The plan must hold at least thirty-percent (30%) of the stock immediately after the sale.
7. §404(a)(9). Limits vary depending on whether a loan is present to allow the purchase of the stock and the percentage of stock of the company purchased by the ESOP. Additional contributions are allowed for so called "leveraged" ESOPs where there is a loan to purchase the stock.
8. Winsby, Roger. Axiom Valuation, 2003