"Failing to plan is planning to fail."

– John Wooden

Business Succession Planning

According to statistics published in the Harvard Business Review, less than 1/3 of family businesses survive from the first to the second generation. The figures get worse from there: only about 10% of those businesses survive from the first to the third generation.

The obvious take away from those statistics is that most businesses simply don't have an effective business succession plan in place to transition the operations successfully beyond the original entrepreneur's generation. What does a lack of a succession plan or a failed succession plan mean for the entrepreneur and his family? It could mean a number of things:

1. Perhaps business assets are unnecessarily overexposed to estate tax and/or income tax;
2. Maybe the business assets are sold at a "fire sale" for pennies on the dollar;
3. Sometimes customers are lost while uncertainty runs rampant during a delayed transition;
4. Employees (even family employees) who depend on the business for their livelihood may well be displaced; and/or
5. Commercial loan covenants may come into default causing an unexpected or expensive refinance or even foreclosure.

Certainly, the above isn't an exhaustive list of potential problems. The real problem is a failure to plan.

When Should I Plan For My Business Succession?

The short answer: start now.

You don't have to relinquish all control over the assets of your business in order to begin putting a plan in place during your lifetime. Some businesses can be transitioned at the entrepreneur's death solely through careful estate planning, but those situations are few and far between. Most successful business succession plans inevitably involve a lifetime strategy to transition operations to a successor operator which is perhaps brought to completion through estate planning.

Consider this: if business succession isn't begun in earnest during your lifetime, who will mentor the successor operator? How will customer/supplier relationships survive? In a business purchase situation, will the successor have enough time to purchase the business and still achieve financial security if the process isn't begun until your death? How will you monetize the value of the business to supplement your retirement? What will happen to banking relationships?

Who Is Involved In Planning For Business Succession?

The obvious truth here is that you have to pick the right successor or the whole plan will struggle to get off the runway. Frequently, only you know who is appropriately qualified to be the successor operator, but that individual (while no doubt indispensable) isn't the only party involved in the succession process.

In our experience, both you and your spouse need to be on the same page in order for a business succession plan to be effective, regardless of who actually owns the business. Particularly when transitioning a business to one or more children, unity at the parents' generation is frequently an essential element to accomplishing the intended goals of the plan.

Additionally, if there are children in the family who are not going to be successor operators, those children wind up (through no action of their own) being an important consideration in the succession process. For example, suppose the value of the family business makes up 80% of your net worth. Suppose further that you don't intend your successor operator child to pay 100 cents on the dollar for the business. In that case, what do you intend to do for your non-operating children in terms of estate planning or other gifting? Do you intend to treat all children equally? Perhaps the successor operator should get more given his or her involvement in the business? Did I mention yet that it's important for spouses to be on the same page?

Finally, a cabinet of good advisors is always recommended in order to accomplish an effective plan. As attorneys, we enjoy working side by side with the family CPA and financial advisor to ensure that all the family's targets are being hit.

How Is Family Business Succession Accomplished?

Creative solutions are paramount in the family business setting, but, in very general terms, the "how" of the equation begins to come into focus when you answer the following core question:

How much value do I need to realize from the business during my retirement years in order to live the lifestyle I want to live?

That question drives the entire methodology for accomplishing the succession process. For example, if you've made all the money you care to make then you can just give the business away to your operating children and they can pick it up and run with it. If you'd rather not give it all away (as is the case many times), then we have to investigate selling all or a portion of the business to the successor operator. Perhaps it can be structured as a part sale/part gift transaction. Perhaps the operations can be transitioned to the successor operator while you hold onto strategic real estate and receive rental income to fund your retirement. In any event, it's largely driven by the degree to which you want or need value from the business during retirement.

Once you determine what you need from the business to retire, the focus can shift into more technical issues surrounding the obligations and restrictions of the parties involved, banking issues, etc.

What Am I Transferring To My Successor Operator?

The answer to this question is really a choice between two different options:

1. Assets of the business; or
2. Corporate stock or LLC interests representing ownership of the business.

In industry terms, it's a choice between a stock deal and an asset deal. Embedded in that choice are myriad issues surrounding legal structure of businesses, contracts or licenses currently in place, intellectual property, income tax issues, basis issues, among other concerns.

In a family setting, transferring stock or LLC interests is frequently an attractive option due to the relative ease of transferring the business. The ownership is transferred on paper only and the existing organization stays in place. The tax identification numbers don't change. Payroll and accounting systems can stay in place. Real estate doesn't have to be transferred. Vehicle titles don't have to be renamed. Favorable contracts or licenses stay in place and don't have to be renegotiated or resubmitted.

However, one of the primary problems with a stock or unit transaction is that liabilities continue with the business. Contrast that with an asset deal. For many liabilities (but not all), an asset purchase can allow the successor operator to take over the business without being subject to unsecured liabilities of the previous operating group.

In any event, this is another of those decisions that requires professional advice to arrive at the best choice for you.

What About Taxes?

No one wants to pay any tax he doesn't absolutely have to pay. Certainly, an important part of the planning process involves strategic cooperation among your attorney and CPA to ensure that available tax minimization strategies are being effectively utilized in both the estate tax and income tax arenas.

From an estate tax perspective, while Ohio has repealed its estate tax, the federal government still collects a unified transfer tax for both lifetime gifts and estate transfers. The exemptions are now much higher than in the past and are indexed for inflation, but the rates in the federal estate tax program are high enough that failing to plan for estate taxes in those estates that are subject to the tax can be devastating to a family business.

Gifting property doesn't generate an income tax for anyone (but basis rules may influence decision making). However, selling the business may very well generate income tax issues that should be carefully analyzed to ensure that taxes owed are being minimized.

Putting It All Together:

American communities are frequently built upon the backs of the small and medium sized business owners. Unfortunately, as noted above, all too often those businesses don't survive multiple generations, which impacts not only the family business, but also employees, families and communities. Our firm has been working with closely held family business for more than 40 years and can help you make sure your business doesn't become a statistic. Just ask us how.

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