FAMILY BUSINESS

Transitioning the Family Business

HOW TO CREATE AN EFFECTIVE SUCCESSION PLAN

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Less than one-third of family businesses survive to the second generation, and less than half of those survive to the third. The reason for these alarming numbers is quite simple: many business owners do not have a comprehensive business succession plan. For those business owners interested in passing their business on to the next generation, the following is a list of key issues they must consider to design and implement an effective succession plan.

Identification and Development of Leaders

Whether the principal's successor is a family member or trusted associate, someone must be groomed to immediately step in when the principal leaves the business. Business acumen and leadership are not developed overnight; they are established through experience and training, both of which take time. Moreover, it is important for the principal to help her successor develop relationships with customers, vendors and employees so that everyone is confident that the successor can run the business after the principal is gone.

Governance Structure

One of the most important considerations is who will have a vote in the control of the business as an owner. Often, certain members of the family are integral in the day-to-day operations of the business, while others have no involvement at all. Also, there may be unrelated individuals who are critical in the management of the business. The division of control among various interested groups can be very difficult to determine, but there are tools to help establish a well-considered ownership structure, including voting trusts and different classes of stock, such as voting, non-voting and preferred interests.

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Financial Security After Retirement

Implementing a succession plan does not mean the principal has to give up cash flow from the business. The principal can be paid a management/consulting fee, director's fee or a preferred return on the interests retained. Moreover, the principal can sell interests to a grantor trust tax-free in exchange for annual installment payments.

Estate Planning

Although a well-drafted will or revocable trust is essential to the orderly transfer of ownership upon the principal's death, lifetime transfers can save substantial taxes without affecting the principal's control over the business. At the appropriate time, the principal may divest control, thereby simplifying administration of the principal's estate and saving costs.

Taxes

To the extent a principal owns the business at death, estate tax of up to 40 percent on the value of the business may be due nine months after death, potentially placing a sizeable burden on the business. With proper planning, however, tax-free liquidity from outside the estate can be made available to pay the tax bill. Moreover, elections may be available to exclude a portion of the value of the business from estate tax and extend the payment of estate tax over a period of almost 15 years.

Asset Protection

The business can be threatened by liabilities generated from its operations (inside liabilities) as well as personal liabilities of the individual owners (outside liabilities). By isolating lines of business in distinct entities, an owner can keep an inside liability in one line from threatening the operations of another. Further, implementing irrevocable trusts into the ownership structure can minimize or even eliminate the impact on the business of outside liabilities, such as an owner's bankruptcy or divorce.

Family Governance

The death of the principal can dramatically change the family dynamic, especially when a valuable business is involved. Anticipating and implementing procedures to handle conflicts can make the difference between maintaining a thriving business and ending up in lengthy and expensive litigation. By carefully structuring the ownership of the business and incorporating buy-sell agreements and alternative dispute resolution clauses, the principal can reduce the amount and impact of disputes.

Communication to the Next Generation

Often, failing to meet a beneficiary's expectations can lead to costly litigation. Thus, it is best if there are no surprises when the principal leaves the business. During her life, the principal should communicate the succession plan to each family member, whether he or she is positively or negatively affected by the plan. Generally, it is much easier (and cheaper) for the principal to manage disputes than for the beneficiaries to resolve them after the principal is gone.

As you can see, a comprehensive business succession plan will address an array of issues and take time to fully implement. However, the chances of the business surviving to the next generation dramatically increase with a proper succession plan.◆