Business Succession Planning: Ensuring a Smooth Transition

After their father passed away in 2012, Joan, Sean and Robert Jacobs thought they would simply take over his successful small business. But like many small businesses, this one was closely managed by Mr. Jacobs, its founder, who had no succession plan in place. The children soon found themselves mired in conflicts about who would lead the business, how it would be run, and how they might cash in. Over the course of the next two years, they battled among themselves as the estate languished and the rudderless company slid into the red. Eventually, the business was sold at a fraction of its former value and the family was badly divided.

Sadly, this illustration is not uncommon. According to recent surveys, most small businesses are inadequately prepared when it comes to succession planning. Although 40% of family-owned businesses plan to pass on management and ownership to the next generation, 44% have no succession plan in place and only 18% have identified individuals to fulfill the most senior roles. This lack of preparation is a major reason why only 30% of family businesses survive into the second generation, and only 12% are still viable into the third generation.1,2

As the Jacobs’ experience illustrates, there is much more to passing on a family business than just transferring ownership. There are matters that impact control, aligning business and personal goals, and accommodating the often disparate needs and interests of heirs. There are also structural considerations that can dramatically affect the value of the estate and taxes.

This paper will examine the succession planning process, look at some common succession strategies and structures, and consider several case studies of successful transitions. It will also look at succession planning pitfalls and best practices that business owners can take to better ensure a smooth transition.

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The succession planning process

When it comes to succession planning, there is no “one-size-fits-all.” Every business and family situation is unique and calls for its own tailored approach. But there are common steps that business owners can take to put a succession plan in place. These key steps are relevant to almost all family businesses and can help create a viable succession plan—one that provides for the financial independence of retiring owners, the transfer of ownership and control, and the positioning of the business for continued growth and success.

1 SET GOALS

Establishing an effective succession plan begins by setting specific objectives. Ask yourself: What is it you wish the plan to accomplish? You will want to identify a collective vision for the business as well as for the family. This is the stage when you should determine if the business is to continue to be owned and managed by the family. This is also when you will want to identify ownership shares and which heirs may wish to cash in their ownership interests. You’ll also want to determine the retirement goals and cash flow needs of retiring owners. It is often a misalignment of these critical goals that causes future disputes, so make sure to involve family and heirs and to encourage open and frank discussion.

2 IDENTIFY MANAGEMENT SUCCESSORS

A good succession plan will not just identify who runs the business, it will also define active and non-active roles and the reporting structure of senior management. You’ll also want to establish a decision-making process and a method for dispute resolution. This is particularly important for larger businesses and those where multiple family members will be involved. While many business owners envision children or heirs as future managers, they should also consider the option of bringing in professional management. Again, an open and frank dialogue between all parties can be critical to future success.

3 INTEGRATE YOUR ESTATE PLAN

A business often represents a business owner’s greatest asset. Accordingly, a succession plan should be an integral part of an estate plan. You’ll want to address tax implications to the owner/business upon sale or transfer of ownership, death, or divorce. It is at this stage when you will want to consider which structure or strategy might best suit your needs and minimize taxes. You will also want to solicit legal and professional advice.

4 DOCUMENT AND COMMUNICATE THE PLAN

Once you have determined the terms of a plan, it is important to set it down in writing. While all the structural aspects will need to be detailed in legal documents, you should also document the arrangements for ownership and control of different heirs. Then, share the plan with heirs and make sure all are aware and in agreement with the terms of the plan. The more buy-in you get from all parties, the less likely there will be disputes down the road.

5 CREATE A TRANSITION PLAN

A comprehensive succession plan typically incorporates a transition plan whereby ownership and control do not simply switch upon the death of the owner, but transition over a period of time. Such a plan will also phase in the successor or ownership, and may set benchmarks or goals for heirs.

“It is important to have a succession strategy discussion early to avoid big problems later. Plan at the onset and modify as the business grows and changes over the years. No one likes a forced fire sale except for the person buying the business at a large discount.”

Jason Liu
Head of Wealth Planning
Union Bank
Transfer strategies

While there are many different ways to transfer a business to heirs, the legal structure of the business and method of transfer are the cornerstones of a succession plan. Different strategies accommodate different needs. For instance, a buy-sell agreement is often used to secure stable ownership. Life insurance is typically used to provide liquidity and equitable treatment to those children who are not involved in the business. And gifting ownership shares is often used to reduce estate taxes. In practice, a combination of different strategies is used to accommodate the specific goals of the plan.

Buy-Sell Agreement: One of the tools used to transfer ownership and provide for the orderly succession of a family business. It allows the business owner to enter into an agreement that provides for the future sale of his or her interest, should death, disability or retirement occur. It also ensures control over the business by the surviving or remaining owners and can help to establish the value of the business interest for estate tax purposes.

Employee Stock Ownership Plan (ESOP): A qualified defined-contribution employee benefit (ERISA) plan that is designed to invest in the stock of the sponsoring company (employer) while providing tax advantages to both employee and company owners. The company can make tax deductible contributions to the ESOP that is used to purchase company stock. Owners selling stock to the ESOP benefit by deferring tax on the sale of their stock. Generally, there is no out of pocket cost to employees and the growth in the stock value is tax deferred. Owners can decide how much and how fast they wish to liquidate their stock, subject to IRS limitations on qualified payroll and maximum annual percentage of qualified payroll. ERISA anti-discrimination provisions make for a fair allocation of stock to participants.

Trusts: Can sometimes be used to provide continued income to the business owner and his or her spouse. Any kind of property can be transferred to a trust, including a business. After the life of the trust, the assets can be given to beneficiaries such as family members, charitable organizations or others. There are many different types of trusts which can allow the owner to retain a certain amount of control over the business and provide a vehicle for succession.

Gifting: Given throughout the owner’s lifetime, this is a common strategy to help reduce estate taxes. Typically, assets are removed from the taxable estate and gifted over a period of years. Gifts valued at $14,000 per beneficiary per year are tax free and reduce the taxable estate. Often, owners will gift non-voting shares in order to maintain control. Such shares may be entitled to a minority/lack of control discount.

Life Insurance: Often serves several different purposes in a succession plan. It is frequently used as a funding mechanism for paying estate taxes, since business interests usually cannot be readily liquidated. It can also be used to equalize an estate—providing children who are not involved in the business with equitable shares of the estate. Life insurance can also be used to provide a hedge against the business owner’s premature death.

CASE: Using life insurance to equalize

George and Sarah run a thriving video production company. Their youngest son Andrew is active in the business, their other two boys are not. They wish the children to be equally treated, but they also want to reward Andrew’s commitment to the business. They realize that dividing the business equally is unfair to all three children, especially Andrew, who would be beholden to his brothers for life. Working with a wealth strategist and soliciting input from all three children, they decided to leave the business to Andrew and to set up a second-to-die life insurance policy which, together with their non-business assets, will be left to their other two children. The strategy will help ensure a continuation and smooth transition of the business, while affording equitable treatment to all three children.
Succession planning pitfalls

Even businesses with a succession plan in place may encounter hazards that can derail a well-constructed strategy. Below are some snags that business owners often encounter when transitioning their business to the next generation.

Waiting too long
If you want to pass your family business along to the next generation, putting off business succession planning is the worst thing you can do. Many business owners are so intensely focused on running their day-to-day business that future planning takes a back seat. They procrastinate until a crisis occurs, or they cobble together a plan that does not address many succession issues and stakeholder concerns.

Fearing loss of control
Many entrepreneurs fear that succession planning will require relinquishing control of the company they’ve spent their lives building. But the opposite is true: a well-designed, properly implemented plan can ensure that the business owner maintains control, both now and in the future.

Not preparing the next generation of management
Running a business is not an intrinsic skill. Even the most enthusiastic and devoted successors need to be exposed to the leadership and ownership issues that they will face. A family business succession plan will have a much better chance of success if you work with your successors for a year or two before you hand over the reins.

CASE: Outdated plan
The Hanford Company was founded and jointly owned by two brothers, Charles and Graham. When Graham unexpectedly died, Charles was forced to execute a buy-sell agreement that the brothers had put in place 10 years earlier. But the outdated agreement provided for Graham’s estate to receive an amount that far exceeded the actual market value of the business, which had declined in recent years. The company did not have sufficient liquidity to pay off the deceased shareholder’s estate, and Charles was forced to liquidate a portion of the business and obtain a business loan just to meet the obligation.

Stakeholders in succession planning
A successful succession plan should address the needs and interests of owners and family, as well as managers and employees of the business.

Putting yourself in a position of financial dependence upon your heirs

Even the most thriving business and closest family bonds cannot guarantee the future financial security to departing owners once ownership and control are passed on. A transition plan should always specify the detailed financial terms of succession.

Dividing business equally among participating and non-participating heirs

Attempting to treat children equally with regard to management, leadership, and ultimately control of the business can be a risky proposition. In most families, children differ widely as to their interest in the business, career motivation and management capability.

Not documenting terms of succession

A succession plan is only as good as the formal documentation of the plan. The best planned succession can fall apart unless its specific terms—including successor roles—are specified in writing.

Allowing a succession to become outdated

Businesses change. Roles change. People change. An outdated succession plan can prove a liability if the terms do not address current circumstances.

Key ingredients to a successful plan

The successful transition of a business to future generations often depends on a number of different elements. The legal structure must suit the strategy. The strategy must address the sometimes disparate interests of heirs. And the successors must be suited to carry on the business. While a comprehensive plan will address these and other points, below are five best practices that business owners can follow as they plan their succession.

1 INVOLVE FAMILY IN DISCUSSIONS AND ENCOURAGE INPUT

Deciding on your own succession plan and then announcing it is the surest way to foment disagreement. If family or other heirs do not agree with its terms or have input, the plan stands little chance of success. Creating an open dialogue among family members is the best way to begin the process—one where close attention is paid to the personal feelings and expectations of everyone concerned, as well as the goals of the business. It is also a good way to identify potential conflict areas up-front.

2 CHOOSE BUSINESS SUCCESSORS WISELY

Just because a child is your child does not mean he or she is qualified or interested in leading your business. Examine the strengths of all possible successors as objectively as possible and think about what’s best for the business. There may be no family members capable of or interested in continuing the business and, in many instances, a non-family member may prove to be a better fit. It is important to keep in mind that management and ownership are different business succession planning issues. A well-structured plan will address both.

CASE: Transferring ownership to key employees while maintaining control

Dennis founded and built a leasing company that catered to the construction industry. He is single and has one son who is not involved in the business. Dennis’s estate plan provided adequately for his son with non-business assets and life insurance. He sought a business succession plan where he would continue working and taking income from the company, but slowly transition the company to his five long-term employees. He looked at several options, including an ESOP, but since he really only wanted to benefit a handful of employees, the ESOP didn’t make sense. Working with his wealth strategist, his CPA and attorney, Dennis put together a program to provide bonus stock to the employees over a scheduled time period, allowing him to retain majority control and eventually transition into a long-term consulting contract.
Define Your Role and Exit Strategy

Succession planning starts by determining your personal goals. How and when will you transfer control? What role do you foresee yourself playing in the transition process? How will you be compensated, before and after you retire? A succession plan should spell out the specific terms of exit and retirement and what you will expect from the business once it is being managed by your successors. And keep in mind that transferring ownership does not necessarily mean relinquishing control.

Start Early

It is never too early to make a succession plan. A thoughtfully constructed succession process can, and may, take several years. Entrepreneurs looking for funding may want to build an exit strategy into their business plan from the start. The longer you spend on succession planning, the smoother the transition process is likely to be. You should also make a point to revisit the plan periodically to make sure it is current and addresses current circumstances.

Assemble a Trusted Team of Advisors

A succession plan can involve a change in legal entity, a recapitalization, reorganization or even a future sale of the business. Virtually any plan will involve legal and financial aspects that demand the expertise of a lawyer or accountant. When choosing advisors, you will want to make sure that they have a full understanding not just of the business aspects, but also of the personal and emotional context in which succession planning takes place. This is where an experienced wealth strategist can be of particular use, navigating you through the process and providing invaluable insight.

Your Financial Partner for Life

You’ve worked hard during your lifetime to build your business, and undoubtedly want to ensure the preservation of your legacy. The Private Bank can help. Drawing on a tradition of excellence, personalized service, discretion and respected investment experience, our highly specialized and experienced wealth strategists can help you navigate the complexities of succession planning. Our specialists will work with you to understand your unique situation, and make customized recommendations and actually implement them. Take the next step and discover how we can help you protect the wealth you’ve worked so hard to build.

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What’s your excuse?

When asked why they don’t have a succession plan in place, respondents gave the following reasons:

- I don’t have the time required to deal with the issue
- It’s too early to plan for succession
- I can’t find adequate advice/tools to start
- It’s too complex
- I don’t want to think about leaving
- There is too much conflict with family or employees

Source: Family Business Institute, Inc., 2016, based on a survey by the Canadian Federation of Independent Business.