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Closely Held Businesses: You Make the Plan, or a Plan Will Be Made For You

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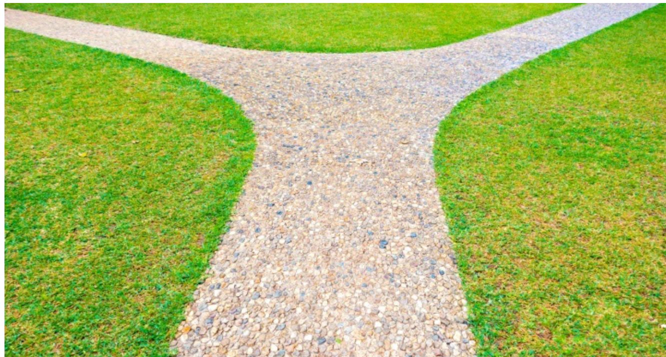

Who is the Better Planner for Your Affairs: You or the State?

Planning for succession of a closely held business is a lot like making a will. An individual has the opportunity to make a will which directs how the individual's final affairs will be handled and property distributed. If an individual fails to make a will, the state provides a set of rules that provide how the final affairs will be handled and property distributed, but it may not be what that individual would have wanted if the time to make good decisions and implement a will had been taken.

Similarly, the owners of a closely held business have the opportunity to create and implement a plan that will provide for new leadership and ownership of their business. If they fail to do so, the "plan" is chosen for them by the state through the operation of state law. In most cases, when the owners fail to plan, the result is that their business is sold or liquidated at an inopportune time, when the owners die or otherwise are unable to run the business. Many business owners have this latter "plan" and they don't even know it.

What Should a Succession Plan Include?

At a minimum, a good succession plan answers two questions for the owner of a closely held business:

- How will my business operate without me? and,
- Who will own and control my business when I give up ownership and control?

In order to begin to answer those questions, it's very important for the owner to start with an examination of the owner's goals for the succession plan. The relative importance of a business owner's goals should guide the decisions which must be made in preparing a successful succession plan.

Some common succession planning goals for business owners are how to:

- Provide for continuity of the operation of the business;
- Maximize the value of the business and/or the income produced by the business for the benefit of the owner and the owner's beneficiaries;
- Provide a livelihood and a place to work for the owner's family;
- Secure the owner's legacy and/or continue the owner's mission; and,
- Provide security for the business's employees.

In some cases, business owners will even take into account the effect of their succession plan on other related businesses, such as suppliers or vendors to the business and the business's customers.

The right succession plan for one business owner could be very different than one for another owner, depending upon their respective goals.

For a given business owner, maximizing the wealth of the owner and the owner's family may take a back seat to the owner's desire to maintain a great place to work for loyal employees. But in contrast, a business owner with less saved for retirement may not have the luxury of foregoing wealth in order to provide the best scenario for those employees.

One business owner may choose to forego an opportunity to sell a business for great profit when that owner's children have a strong desire to continue the family legacy by running the family business. But another business owner may have children who have no desire to work in the family business and would rather have their family legacy liquidated and invested in something with less risk than a closely held operating company.

What Succession Plans are Commonly Chosen?

After taking into account the goals of the business owner, most succession plans will fall into one of four broad categories:

- The business will be sold to an unrelated third party—usually a strategic buyer in the same industry or an investor entity (e.g., a private equity group);
- The business will be transferred to some or all family members of the owner who will own and manage the business;
- The ownership of the business will be transferred to some or all family members of the owner, but the business will be managed by non-family employees of the business; or,
- The business will be sold to non-family employees of the business who will manage the business—either directly or through an employee stock ownership plan (ESOP).

When Should a Succession Plan Be Made?

Regardless of the succession plan the business owner choses, it's very important to plan years in advance to facilitate transfer of the business. Most important is creating a management structure that will not rely heavily upon the business owner to carry on the management of the business. Whether the business is being transferred to family, employees, or an unrelated third party, the business will have less value if the business owner ends up being essential to the operation of the business at the time the operation of the succession plan is triggered.

Training the right person or people to manage the business takes years. In some cases, business owners initially make the wrong choice for successor managers and are forced to choose new ones and start the training process all over again, adding more time to the process.

Ensuring the Effectiveness of a Succession Plan

Once the business owner has established the right management succession plan, it's critical to ensure that it stays in place. With family members who will take over management as well as ownership of the business, this is generally not an issue. However, great managers who will not ultimately own the business are marketable assets who could be lured away by competitors. For such non-owner managers, the business owner must create incentives for them to stay and continue to make the business thrive.

A combination of incentives and deterrents can be an effective way to keep a great manager. For example,

the business owner may offer an incentive compensation plan which rewards the manager with bonuses for growth and profitability of the business.

One good way to do that without transferring ownership of the business is through stock appreciation rights or "phantom" stock, which mimic actual stock ownership in the company by providing bonuses to the employee receiving them based upon growth and profitability. The right to receive the bonuses may vest over time, to encourage the employee to stay at the company, and may be taken away for certain bad behavior, like competing with the business.

At the time a manager is given the incentive compensation plan, it's appropriate to create a deterrent to the manager leaving by requiring the manager to execute covenants not to compete with the business or solicit the business's customers and employees.

With the appropriate mix of rewards and deterrents, key managers will remain loyal to the business.

Planning the Transfer of Ownership; Tax Implications

When the next generation of key managers is in place, and measures have been taken to keep them, the business is ready for any of the options for transfer of ownership mentioned above or any variant the business owner choses. The business will be an attractive target for acquisition by a third party or, if the plan is to transfer the company to family or employees, the business is ready for the remaining work of efficiently transferring beneficial ownership and control of the business. The transfer may be achieved while the business's owner is living or at the owner's death, or consistent with a plan transferring some during the owner's life and some upon death.

A key consideration in the transfer of ownership of the business is minimizing estate and gift taxes, as well as income taxes. With proper estate planning, a business owner can make full use of the available deductions and transfer tax exemptions at the owner's death. With lifetime gifting strategies, the owner can transfer interests in the business while the owner is living, allowing future appreciation in the value of the business to accumulate outside of the owner's estate, while the owner maintains control of the business. Through the use of voting and non-voting interests in a business, it's possible to transfer the bulk of the value of the business to the owner's intended beneficiaries, whether family or employees, but keep the right to control the business until the owner is ready to give it up.

Other key considerations in the transfer of a closely held business are privacy of the parties, efficiency of the transfer, and asset protection. These considerations may be addressed with trusts and separate holding companies, among other planning techniques which are beyond the scope of this article. Such estate and gift planning can be complex, but with the assistance of the owner's estate and tax attorneys and tax accountant, the appropriate planning tools can be developed and implemented. The tax savings can be dramatic and the resulting plan will be manageable for the owner and the transferees of the business.

Summary

For most business owners, the time to begin succession planning is now. For many, it may be too late to fully achieve their goals, but ignoring the issue will certainly limit the choices they have and could lead to unintended consequences.

There are many complex issues and strategies to consider, but with some effort a succession plan can be developed that is consistent with the unique considerations applicable to the owner and the owner's business — and that achieves the same peace of mind that individuals have after making a will.

Make succession planning a priority for your business and seek the help of your legal and tax counsel to get you started.

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