

JULY 2010

Carolina BUSINESS™

NORTH CAROLINA'S BUSINESS TO BUSINESS JOURNAL SINCE 1985



Are You Immortal?

According to the small business administration, only 30% of the country's family owned small businesses survive to the second generation, and only 15% make it to the third. One of the primary reasons small businesses fail is that they do not have a written succession plan. Without a clear plan in place, the typical business will flounder and fail at the loss of the company's leader.

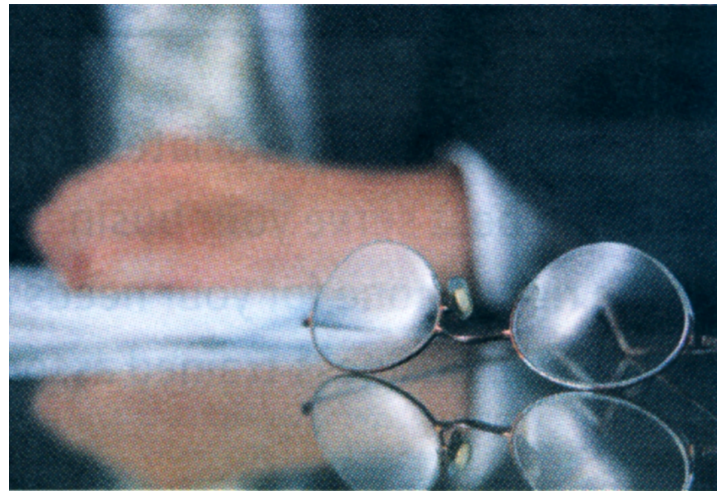
Yet, according to the Laird Norton Tyee National Family Business Survey, 71 percent of small family businesses have no succession plan. It is easy to see why many do not.

- Most business owners do not have the experience to deal with the complex, multi-disciplinary, issues involving succession planning, such as estate planning, tax accounting, wealth management, insurance, and family counseling. Moreover, many business owners find it difficult to balance their needs with those of their family, children, and other stakeholders.
- Most business owners focus on day-to-day operations rather than planning five to ten years out. This problem is further compounded today by the state of our economy, the worst economic downturn since the Great Depression. Many businesses are fighting for survival.
- Lastly most businesses represent the majority of the owner's net worth and the primary source of his income. Some business owners are unwilling or unable to give up control.

Despite the obstacles, a business must have a clear cut succession plan in place if it is to succeed long term. Although no business owner ever plans to fail, many fail to plan, and the outcome can be the same: failure.

Create a Succession Game Plan. The first place to start is to realize that you need outside help. You can start by assembling a team of professionals composed of your attorney, accountant, and financial advisor. Here are some tips:

1. Realize that it is a work in progress and it will change. There is an old adage, "play with the cards you are dealt". Develop the plan based on what you know today, not conjecture.



2. Assume a three to five year planning horizon and update the plan annually or after a significant change in events.
3. Have a family meeting. Determine if the business is going to stay in the family or be sold.
4. Have a heart-to-heart conversation with each family member and shareholder. You will need to hear, understand, and acknowledge the concerns and desires of your spouse, and other family members who may or may not be actively involved in the business, as well as other shareholders.
5. If your plans are to sell the business, you will need to focus on improving your balance sheet and income statements. Most buyers want three to five years of consistent performance.
6. If your plans are to keep the business, you must groom the new leadership. The Laird Norton Tyee National Family Business Survey reported that fewer than 40 percent of businesses have a successor in place and are preparing for the transition.
7. Decide whether leadership will stay in the family. The American Express® Small Business Monitor, reported that 61% of parents would like their children to join the business. Yet nearly two thirds of businesses have no written succession plan. If your children are going to take over the business, you need to document it.

8. Realize that you may need to consider outside talent. The Laird Norton Tyee study reported that 25 percent of businesses think that the next generation is not competent to move into the leadership role.
9. Pick a year when you will relinquish your duties and transfer control to your successor. Be specific. There is beauty and magic in picking a date.
10. Implement a buy sell agreement in the event you die prematurely.

Here are a few strategies that can be used to transfer or sell your business.

Buy-sell agreement.

The agreement will provide for the orderly transfer of your business at your death and establish a market price for estate tax purposes. The most common types are “cross-purchase”, “entity purchase”, or “trusteed” buy sell agreements. In a “cross-purchase” arrangement, you and your partner agree to buy each other out upon your death at prearranged terms and pricing. With an “entity” arrangement, the company agrees to buy out your shares. Lastly, with a “trusteed” buy sell agreement, the agreement is executed with a stand-alone trust, which may help reduce estate taxes and/or simplify the number of parties to the selling agreement. The best type depends upon your specific situation.

To ensure that the purchase price is funded, you can buy an insurance policy on your life. When you die, the business will be sold and the proceeds will be transferred to your estate as cash. This makes it easier to distribute your estate among your spouse and other beneficiaries, and no portion of the business will need to be sold to pay estate taxes.

Transfer through inheritance.

One way to pass your business to your family is through your will. Unfortunately with an estate tax that as high as 45 percent, your heirs could be forced to sell the business to pay Uncle Sam. One way to avoid this is to establish a trust to buy an insurance policy on your life. Upon your death, the policy’s proceeds can be used to pay the tax bill.

Sell with a financing strategy.

If you are financially reliant on your company, but you want to retire or pursue other interests, you may wish to sell the business to your children so you can use the proceeds to support your lifestyle and new endeavors. There is one key challenge to this approach: your kids will need to come up with enough money to fund the purchase.

Fortunately, several financing strategies can minimize this burden:

- *Installment sales:* The buyer makes fixed payments over a period of time based on a prenegotiated schedule. Your kids won’t have to come up with the full purchase price up-front, and you won’t have to

report taxable gains until the year in which you receive payments.

- *Self-canceling installment notes (SCINs):* Similar to an installment sale, the buyer’s payments and your taxable gains are spread out over a fixed period of time. The difference is that the payments are canceled upon your death. So if you die before fair market value is paid, your children get a bargain price. The buyers, however, are required to pay a premium to compensate you for the risk of premature death. Otherwise, the exchange could be considered a gift and subject to gift taxes.

Transfer with gifting strategies.

Any gifts that you give during your lifetime, including gifts of business equity, are subject to the IRS’s gift tax. Fortunately, the IRS offers a \$13,000 annual exclusion per recipient, which allows you to give away a portion of the business over a period of time without getting hit by gift tax.

Family limited partnerships (FLPs) or family limited liability companies (LLCs) are commonly used to facilitate the gifting of a business. An FLP is a limited liability entity in which both general partnership and limited partnership shares are created. You retain the general partnership shares so you can retain full control of the business. Over time, you give away limited partnership interests to your family, within the limits of the gift tax exclusion. The benefit of the FLP is that limited partnership shares can typically be discounted—by as much as 35 percent—because of restrictions on the right to liquidate or transfer the share. Keep in mind that this discount may be reduced or eliminated when the Obama administration updates the tax code.

These strategies involve complicated financial, estate, tax, and legal considerations. That’s why it’s a good idea to establish a team of experienced professionals—an accountant, an attorney, and a financial advisor—to help you develop the right succession plan for you. Your team can help you weigh the pros and cons of each transfer strategy and determine the one that is best for you and your family.



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