Legacy by Design, LLC

A Systematic Approach to Business Succession Planning

Succession Planning

Farmers, Ranchers, & Family Business Owners

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Kevin Spafford, CERTIFIED FINANCIAL PLANNER™, helps farmers, ranchers, and family business owners plan for succession. Kevin's planning process is designed to enhance the family's financial security, create a smooth ownership transition, and mitigate the tax consequences.

As the architect of the *Farm Journal Legacy Project*, Kevin effected consumer behavior and improved the way family business owners engage in the succession planning process. Through the *Project*, Kevin has:

- Published more than 300 columns in Agriculture's leading magazines.
- Facilitated workshops for thousands of farm and ranch families across the U.S.
- Written multiple workbooks and created several client planning tools.
- Produced weekly eNewsletters for subscribers across the country.
- And, hosted 5 seasons of '*Leave a Legacy*' TV.

Prior to the publication of his book *Legacy by Design: Succession Planning for Agribusiness Owners* (Marketplace Books®) in 2006, Kevin founded Legacy by Design, a succession and financial planning firm dedicated exclusively to serving the succession planning needs of farmers, ranchers, and agribusiness owners.

Among a series of professional designations and licenses, Kevin is a CERTIFIED FINANCIAL PLANNER™ and he's earned a Bachelor of Science in Agricultural Management with a concentration in Business, from California Polytechnic State University, San Luis Obispo, CA.

On a personal note, Kevin enjoys flying, fishing, hunting, and camping. He and his wife, Anne-Marie, have been married 37 years. They are proud parents of their son Drew and his wife Dana, and their daughter Sara and her husband Michael. In July of 2018 they welcomed their first grandchild. They live in Durham CA.

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LEGACY BY DESIGN, LLC

A SYSTEMATIC APPROACH TO BUSINESS SUCCESSION PLANNING

Approximately 90 percent of the businesses in the United States are closely held. Unfortunately, many businesses fail to survive the death or retirement of their owner. Although owners often spend a lifetime building their business, many neglect to plan for its eventual transfer to their successors. This failure to adequately plan for management and ownership succession is a leading contributor to the low survival rate.

Although many owners would like their children or other family members to eventually own and manage the business, succession planning is much broader than transferring business ownership from one generation to the next. In many cases, it involves transferring ownership to someone outside the family. Succession planning prepares the business, its owner, and the owner's family for the day when the owner no longer participates in the business. Without planning, that day can create crisis and conflict in both the business and the family, which clearly have adverse consequences both emotionally and financially.

Business succession planning includes developing an exit strategy for the owner and the business. Whether the strategy involves transferring ownership and management responsibility to family members, fellow shareholders or partners, or to a third party, it should address the following issues:

- Providing financial security to the owner after retirement.
- Providing financial security for the owner's family in case of untimely death or disability.
- Ensuring the business's continued success in the owner's absence.
- Dealing equitably with children working in the business and those who are not.
- Limiting ownership in the business to persons acceptable to all owners.

This text addresses the overlap between family and business goals and relationships that is unique to family businesses. This overlap is often the source of conflict that can inhibit the succession planning process. An understanding of this overlap enables the practitioner to design a succession plan that balances family and business goals and minimizes the risk of conflict. In addition, it addresses several commonly encountered barriers to the succession planning process along with techniques and strategies for overcoming them.

WHAT IS A SUCCESSION PLAN?

Planning for an Inevitable Change

Ideally, a succession plan is a comprehensive plan for transitioning a business, its owner, and the owner's family from the current ownership and management structure to one in which the owner is no longer involved. A sound succession plan should address:

- Converting business wealth to assets that can be used to fund the owner's retirement.
- Transferring ownership in the business to the desired successors.
- Treating the owner's children equitably while considering how to divide ownership between those active in the business and those who are not.
- Addressing estate planning concerns associated with the transfer of a closely held business, including minimizing estate and gift taxes, providing liquidity to the estate, and planning for a surviving spouse.
- Strategic planning for the business's success after the transition, with primary focus on choosing and grooming a management successor to successfully run the business.

Transferring ownership in a business is unlike transferring ownership in any other asset. Often, a significant portion of a business' value is attributable to the owner's personality, efforts and relationships. Thus, without planning, the value of the business is likely to decline drastically when the owner is no longer involved. This decline in value certainly can have an adverse effect on the owner's financial situation in retirement. In the event the owner's disability or death forces an ownership change, any decline in the business' value can be financially devastating to the owner's surviving spouse and family.

Overview of Owner Strategies

All business owners have an exit strategy, although they may not be aware of it. These strategies can be placed into the following broad categories:

- Lifetime transfer of ownership interest and management responsibility.
- Estate plan implements the exit strategy.
- Let the heirs worry about it.

Understanding the owner's current level of planning helps the practitioner make suggestions that may move him to a more effective level. For example, an owner who has refused to address the situation might have difficulty implementing a full-blown plan for transferring ownership and management responsibility during his lifetime. Instead, he may be more receptive to planning for his family in the event of his untimely death, which is a realistic concern. As the owner becomes more comfortable with planning, he may be able to move to a more comprehensive strategy.

Lifetime Transfer of Ownership and Management The optimal succession plan usually combines a lifetime transfer of both ownership and management of the business to the owner's successor(s) with a contingency plan that becomes effective if the owner prematurely dies or becomes disabled. The contingency plan is updated periodically to reflect the changing circumstances of the owner's dependents.

A lifetime transfer of business ownership and management responsibility allows the owner to guide and mentor the successors during the transition process. Usually, the existing owner is the best person to facilitate these transitions. The owner's involvement in the transition can also inspire the confidence of employees and key outsiders.

Observation: The owner must have a great deal of confidence in the successor to hand over the business during his lifetime. Beside the emotional attachment to the business, the owner is likely to have continued financial ties (e.g., consulting agreement, installment note receivable, or continued minority ownership) that makes him dependent on the future success of the business. An owner's inability to develop confidence in the successor or to resist the temptation to interfere can be major barriers to the plan's success. Thus, a management succession plan that allows the owner to observe the successor as he or she gradually assumes increased responsibility should build the owner's confidence in the successor and increase the owner's willingness to make a lifetime transfer.

Using the Estate Plan to Implement the Exit Strategy While transferring ownership and management responsibility during the owner's life is optimal, many owners have no intention of retiring. Some business owners are not ready or able to address all the family issues that are encompassed in a lifetime exit strategy, fearing that their succession decisions will cause family tensions. These owners often adopt an exit strategy that uses their estate plan to transfer business ownership at their death.

Even though the ownership and management succession will not take place until the owner's death, this is still a planned succession strategy. As a result, the owner must decide who will acquire the ownership interest and how it will be transferred. A buy/sell agreement funded by life insurance is often used to implement an ownership transfer at the owner's death.

When the estate plan is used to implement the exit strategy, the issue of management succession is often overlooked. Instead, the new owner(s) are often left to determine who will assume management responsibility after the owner's death. If one individual does not own a controlling interest (e.g., ownership is divided equally between children) it may be difficult to agree on who will assume management responsibility. This often leads to power struggles and may pit the siblings against each other. Obviously, this can have a negative impact on the business. Similarly, without the owner available to help the successor(s) transition into the management role, their chance for success is greatly diminished.

Owners who use their will to implement the succession plan should inform family members and key employees of their decisions. This may help them understand and accept the plan and work out any unforeseen problems before the owner dies. Communicating the plan is clearly difficult if the owner's fear of creating family conflicts is the reason for using the estate plan as the succession plan. However, the practitioner should try to help the owner see that no communication is often more destructive to the family than dealing with a difficult situation (e.g., not everyone getting what they want). When owners fail to communicate their plans and the reasoning behind them, family members are likely to misunderstand and to draw inaccurate conclusions about the reasons for the owner's actions.

Letting the Heirs Worry about It This plan has the most negative impact on the owner's survivors and the business. At the owner's death, ownership in the business is transferred under the terms of the owner's will (or, if the owner is intestate, under state law). Thus, ownership may be transferred to various heirs who may not be willing to work together. Ownership may be so fractionalized that decision-making becomes either very inefficient or even impossible, crippling the business. The failure to plan for management succession alone may result in the failure of the business. Failing to give any thought to who will own and manage the business after the owner's death will likely result in the business failing or declining drastically in value.

Why a Team Approach Is Needed

Because succession planning addresses a broad range of issues, a team of professionals is usually involved. At a minimum, an accountant and attorney are usually involved. When outside capital is needed to fund the ownership transfer, a banker or other financial advisor often assists in locating and obtaining funds. If business interests are gifted or sold to related parties, a valuation expert will usually be needed to substantiate the property's fair market value. An insurance professional may also be involved. Finally, in some situations, family business consultants or counselors can help family members deal with tension or conflicts that arise as business ownership and management responsibility are transferred from the current owner.

Practitioners should not hesitate to be involved in devising and implementing a succession plan because they do not personally have knowledge or experience in all the technical areas succession planning must address. The CPA often has a thorough knowledge of the business and sometimes the family, plus usually is a very trusted adviser. This level of trust is invaluable when clients are making decisions about a very significant asset as well as decisions that affect family members and other relationships.

Clearly, no single professional will be able to provide all the services needed to develop most succession plans. A team approach is usually necessary and often beneficial due to the depth of experience and knowledge brought to the table. However, the professional who takes the lead in building the team and accepts responsibility for overseeing the project through the plan implementation may be the most valuable to the client.

Recognizing Factors That Affect the Strategy

When designing the succession plan, it is important to realize that each business owner has a unique personality and situation that may limit the available options for transferring ownership and management responsibility. Some of the more common are discussed in the following paragraphs.

Ability to Relinquish Control Giving up control in the business is very difficult for many owners. Thus, it may be helpful to determine why the owner is unwilling to do so. In some cases, an owner may be concerned that his successors will cause the business to fail. In these cases, helping the owner gain confidence in the successor, perhaps by transferring control gradually, may alleviate this problem. For other owners, wanting to control is a personality trait. This type of owner is likely to be very unhappy if he is convinced to transfer control of the business without planning some other way for him to exercise power. Becoming involved in charitable organizations or serving as a director for another company, for example, may be acceptable substitutes. Practitioners can use their knowledge about the owner's personality to make suggestions about activities that may be appealing substitutes for running the business.

Age An owner's age impacts the management succession alternatives. Generally, the older the owner, the fewer his options. An owner with many years left to work can transition management responsibility gradually, providing the opportunity to see potential management successors in action. The owner can maintain control until the successor is ready to take over. An owner who decides that the successor will not be capable of assuming responsibility still has time to groom another candidate.

An owner's age can also affect the available transfer options. Some transfers may require several years to complete. For example, many exit strategies include at least some gifting of the business interests to family members. The annual gift tax exclusion is a valuable tool for transferring value without incurring gift tax. However, the amount of value transferred tax-free depends on the number of years the owner makes gifts qualifying for the exclusion. Also, many strategies use life insurance proceeds to help successors fund their purchase of the business (or to create an asset for children not active in the business). The owner's age may make the cost of such insurance prohibitive. Because their options are usually limited, owners who delay the planning process are often forced to compromise. For example, they may have to pay more gift tax or finance more of a sale than they would like. Practitioners should make sure their clients clearly state and prioritize their goals. Since some goals may not be feasible, the practitioner should help owners manage their expectations about what can realistically be accomplished.

Condition of the Business A business with a history of profits, a sound customer base, good relationships with suppliers and customers, capable employees, and a plan for the future clearly is more likely to sell (and for a higher price) than a business with weaknesses in these areas. Also, good records and an established set of policies and procedures (rather than the owner making every decision, no matter what level) also enhance the business' value. The practitioner should help the owner assess the business to realistically understand its worth and to identify any actions that could be taken to enhance the value.

Planning Tolerance Practitioners should recognize that each client has a certain level of tolerance for planning, that is, a level of cost, risk, and complexity with which they are comfortable. If the succession plan exceeds the client's tolerance for any of these items, it is not likely to be successfully implemented. Thus, it may be appropriate to adopt an incremental approach to succession planning to avoid overwhelming the owner with the cost and complexity of a comprehensive plan.

WHY EVERY BUSINESS OWNER NEEDS A SUCCESSION PLAN

Like most people, business owners are usually concerned about their own financial security, providing for their loved ones, and keeping their family happy. However, closely held business owners often have the additional concern of keeping the business successful after they are no longer running it, since they (or their family members) often depend on the business to provide continuing financial resources. Even if the owner and family are not financially tied to the business after transferring ownership, the owner may have personal reasons for wanting the business to continue to succeed. A sound succession plan addresses the goals that business owners have for themselves and their family. It can also enhance the value of the business by making it less dependent on the talents of the owner. This allows the owner to transfer ownership in the business without its declining in value as a result of the transfer.

Financial Security in Retirement

Some business owners anticipate and plan for their retirement. Others cannot envision life without the business and have no intention of retiring. Even those who have no intention of retiring must realistically acknowledge that circumstances beyond their control may force them to stop working at some point. An exit strategy ensures that the owner and his family will be able to withdraw adequate financial resources from the business at the owner's retirement, whether voluntary or not.

The amount of financial resources available to the owner (or his family) when the owner is no longer working will be limited by the business's value. Planning for ownership and management succession actually enhances value because planning minimizes potentially costly disruptions and disagreements that can take place when the transition happens without preparation.

Providing for Dependents

Most owners are concerned about providing financial security for their spouse and children during their life and after their death. A closely held business often represents the owner's most significant asset. Planning for the transfer of ownership and management control can ensure that the value of that asset is preserved for the owner's dependents.

Planning for management succession can significantly enhance the business's value and maximize the wealth transferred to the owner's dependents. Without planning, it is very likely that the value of the business will decline because the management successor is inexperienced, unprepared, or not well received by key employees, customers, suppliers, or other important third parties. Also, a sound succession plan minimizes estate taxes on the business and provides liquidity to the owner's estate. In addition, the succession plan can be structured to minimize income taxes on business income or the eventual sale of the business. Both measures preserve cash resources and enhance the financial security of the owner's dependents.

Ensuring the Business's Continued Success

A closely held business is usually more than a way for the owner to make a living. A business often gives the owner power and prestige in the community. It can also represent the owner's legacy to his children, both financially and in terms of family identity. In addition, many owners have strong loyalties to employees and customers with whom they have worked for many years. Thus, ensuring the business's continued success is often a very high priority for the owner.

Planning for transitioning management responsibility is critical to the business' survival after the owner retires or dies and is an integral part of any succession plan. Planning for management succession ensures that the owner's death or retirement will not disrupt business operations, as the management successor is prepared to step in immediately and make business decisions. Also, sound planning for management succession includes introducing the potential management successor to key third parties such as customers, suppliers, and bankers. This enhances those parties' confidence in the management successor and allows him to carry on "business as usual" rather than having to prove himself.

Having a buy/sell agreement is another important way of ensuring that an owner's departure does not adversely affect the business. Without such an agreement in place, the departing owner may transfer his interest to someone who is not qualified to replace him (e.g., a surviving spouse or a child). Giving an inexperienced or unqualified individual a significant ownership stake can cause serious business disruptions. Likewise, a buy/sell agreement typically sets a price at which the departing owner's interest is to be purchased. This can avoid the remaining owners having to spend a great deal of time and energy negotiating with the selling owner (or his estate) over the purchase price.

Finally, a sound succession plan balances the needs of the business with those of the owner, which helps ensure that the business is not adversely affected by actions designed to benefit the owner. For example, plans for the owner to withdraw cash after retirement are evaluated not only by whether those payments satisfy the owner's liquidity needs, but also by their impact on future business operations. This helps ensure the business' continued viability after the owner's departure.

Promoting Family Harmony

Succession planning involves communicating to each family member his or her place in the business. Transitioning management responsibility and ownership in a family business may cause the owner to make some painful choices. However, a planned transfer also forces owners and their family members to discuss their goals with respect to the business. Communicating these goals to each other ahead of time is ultimately much less painful for family members than spending a lifetime hoping their parent's plans for them in the business match their own. Without any succession planning, family members often find out about the owner's plans for management and ownership succession after he is dead and has no chance to explain his actions, which can be devastating.

When the owner has multiple children (especially if some are active in the business and some are not), planning to transfer ownership in the business can avoid pitting the active children against the inactive children. Solutions such as using life insurance to create an asset for the inactive children or to create buyout funds for the active children are available to meet the owner's goal of transferring wealth equitably without creating family conflicts.

Succession planning may also include devising ways for family members to work together for the good of the business. Although every family member might not be chosen for his or her first-choice position, all can be given an opportunity to work and to voice an opinion. Formalizing this process can be helpful, especially when tensions exist between family members. For example, family members can collaborate on a family mission statement or a list of business values. Sometimes creating a family council to make important decisions about the business' direction strengthens the family identity and provides family members an opportunity to work together toward a common goal, which often translates to increased family harmony.

DESIGNING AND IMPLEMENTING A PLAN

Gathering Data

Consulting is, by its nature, not an exact science. Successful engagements depend on the practitioner's ability to extract and process pertinent client information. How this is accomplished depends a great deal on the nature of the practitioner's relationship with the client, the client's personality, and the practitioner's communication style. In some situations, the practitioner and client will be very comfortable discussing sensitive issues. In others, the client may be less willing to share certain information. The practitioner must rely on his own intuition and professional judgement when dealing with each client.

A sound succession plan addresses diverse topics including the owner's retirement, transferring wealth to his heirs, transitioning management responsibility, the income and estate tax consequences of various transactions, and the plan's financial effect on the business' continued operations. Obviously, trying to address all these issues simultaneously is nearly impossible, as any one step may affect the outcome of others. The authors suggest the following methodology as a logical process for devising and implementing an exit strategy:

- Identify and prioritize the owner's goals.
- Identify and prepare the management successor.
- Determine the owner's post-retirement cash needs.
- Review options for funding the transfer.
- Plan for ownership succession.
- Identify options for transferring ownership.
- Integrate the succession and estate plans.
- Develop an implementation strategy.
- Design a contingency plan.
- Monitor and adjust the plan.

Identify and Prioritize Owner's Goals

It is important to understand that owners can view a business almost like another family member. Their commitment to its success and pride in its accomplishments can be as strong the emotions they feel for family members. Often, owners see the business as their own identity. Thus, any succession plan must consider not only financial needs of both the owner and business, but the owner's emotional attachment to the business as well.

A succession plan will have value to clients only if it meets their goals. However, it is not uncommon for owners to have goals that are mutually exclusive or that are just not attainable based on financial realities. Thus, the first and most important step is to identify and prioritize the owner's goals. To the extent goals conflict or do not appear attainable, the practitioner must manage the client's expectations of what the succession plan will achieve. The practitioner and client have to understand what the strategy is before it can be successfully designed and implemented.

Common goals for owners include the following:

- Keeping business ownership in the family.

- Maintaining the business' success and profitability.
- Providing liquidity to owners or their estate.
- Providing financial security for family members.
- Minimizing the owner's current tax liability.
- Maintaining family harmony.

However, there are limitations on the ability to achieve goals. For example, keeping business ownership in the family may not be feasible if no family members are interested in running the business. Also, providing liquidity to the owner may require the business to make payments to the owner (such as non-compete payments or payments for past services), which must be evaluated against the goal of maintaining business profitability.

When helping owners prioritize goals and understand their feasibility, it is important to consider the goals of other family members. Often, the owner's and the spouse's goals may conflict. For example, the spouse may want to promote family harmony by transferring ownership equally to the children. The owner may want to ensure continued business success by transferring ownership to the child most qualified to assume management responsibility. Addressing both spouses' goals will ensure that the succession plan does not create a rift between them. Also, owners should avoid making assumptions about their children's' goals. While an owner may dream about keeping the business in the family, that may be a bad decision for both the business and the family if the children are really interested in pursuing other interests. Likewise, owners may assume the children want to own the business and design a plan that ensures each child receives an ownership interest in the business. However, some of the children may prefer to receive other assets.

For each client profile, typical owner goals and the engagement steps for designing an exit strategy to meet those goals are listed, along with major issues that are usually associated with each step. Each engagement step is cross-referenced to a work program for performing that step. The work programs in this Guide that are cross-referenced (and their related discussions) give additional information on each engagement step.

The five client profiles are:

- Owners with children to whom they would like to transfer the business.
- Owners who want to sell their business to a third party and retire.
- Owners who want to sell their business to a third party and invest the proceeds in a new business or investment venture.
- Owners of a business with multiple owners, who intend to sell their interests to the remaining owners.
- Owners who do not intend to transfer ownership in the business during their lifetime.

Identify and Prepare Management Successor

Successfully transitioning management responsibility is critical to any business' survival. Without a prepared, competent successor ready to assume the role of top decision-maker, the owner's retirement, death, or disability is very likely to cause the business to falter or even fail. Thus, management succession should be addressed early in the succession planning process to ensure a plan is in place in the event the owner is suddenly unable to work.

Although the owner will ultimately choose his management successor, the practitioner can guide him through the following process, which is designed to help the owner make a sound choice and remove barriers to the new manager's success.

- Assess the current and anticipated needs of the business to ensure that the management successor's skills match business needs. This process should be undertaken regardless of whether the successor is a family member or not.

- Perform an objective, formalized assessment of potential management successors' skills. Often, owners with children would like for a child to take over the management role. Having a formalized assessment procedure in place can bring much-needed objectivity into the process.

- Consider recruiting an active board of directors to assist in the selection process. Experienced nonfamily board members can validate the owner's decision, expand the owner's resources, and serve as mentors for the successor.

- Design a plan for developing the successor's skills and experience. This step often applies when the chosen successor is a child who shows promise but lacks seasoning.

- Gain support for the successor from critical third parties such as customers, bankers, suppliers and key employees. Anticipating and addressing the response of key employees who may feel slighted or resent the successor is especially important.

Quantify Owner's Post-retirement Cash Needs

The authors believe the optimal succession plan calls for the owner to relinquish his controlling ownership interest and management responsibility before he dies. However, an owner may be reluctant to retire from the business unless he is confident that he will be financially able to maintain a desired lifestyle. For owners who have relied on the business for income while they worked, the business will likely be the primary source of cash to fund the owner's retirement.

Observation: Even owners who do not plan to retire should have a contingency plan in the event they become unable to work. This plan would have to address sources of funds to maintain the owner's lifestyle after he stops working, just as if he had retired. Thus, quantifying financial needs is a critical step, regardless of whether the owner plans to retire or not.

There are many ways an owner can derive financial benefits from the business after he has given up ownership and management responsibility. Payments for consulting, refraining from competing, past services, or deferred compensation may be appropriate. The owner may also retain significant assets, such as real estate or intangibles, and receive payments for the use of those assets. If the business is sold, the owner receives sales proceeds, often over time.

Besides helping the owner buy in to the idea of transferring ownership in the business, addressing his post-transfer financial needs will help identify which ownership transfer techniques are viable. For example, an owner without other significant assets usually cannot afford to gift large interests in the business to his heirs unless he receives some other form of payments (e.g., deferred compensation) as part of the plan.

The first step in determining how much cash the owner will need from the ownership transfer is to quantify the amount needed to fund his desired lifestyle.

With the exception of fixed payments (e.g., a mortgage) the projected expenditures should be adjusted for inflation. Even if the annual inflation rate is low, its effect can be material when projecting several years in the future. For example, if annual expected inflation is 3%, a $1,000 expenditure today would cost $1,340 in 10 years.

Observation: When projecting expenditures after the ownership transfer, the owner should consider any noncash benefits he is currently receiving from the business. Many owners drive a company-provided car, need company-provided health insurance, or use company club memberships. Because these benefits generally would not be available after retirement, the owner may need to fund them himself.

After quantifying the owner's cash needs after the transfer, cash from sources other than the business (e.g., IRAs, social security, and portfolio investments) is projected.

Inflation Factors

Years	Expected Annual Inflation						
	3%	**4%**	**5%**	**6%**	**7%**	**8%**	**9%**
5	1.16	1.22	1.28	1.34	1.40	1.47	1.54
10	1.34	1.48	1.63	1.79	1.97	2.16	2.37
15	1.56	1.80	2.08	2.40	2.76	3.17	3.64
20	1.81	2.19	2.65	3.21	3.87	4.66	5.60
25	2.09	2.67	3.39	4.29	5.43	6.85	8.62
30	2.43	3.24	4.32	5.74	7.61	10.06	13.27
35	2.81	3.95	5.52	7.69	10.68	14.79	20.41
40	3.26	4.80	7.04	10.29	14.97	21.72	31.41
45	3.78	5.84	8.98	13.76	21.00	31.92	48.33

Finally, the owner's projected financial needs after the transfer are compared to projected cash from sources other than the business. To the extent there is a shortfall, the difference must come from the business.

Review Options for Funding the Transfer

Many business owners are not financially able to transfer their ownership to a successor without receiving (a) consideration when the business is transferred, (b) payments from the business after the business is transferred, or (c) both. The owner's need for consideration when the business is transferred often means that the successor must buy all or a portion of his interest. Thus, the successor often needs funds to complete a transfer. The available sources of funds often determine or limit the transfer options.

The practitioner's role in identifying funding options can involve some or all of the following, depending on the types of funding available or desired:

- Determine amount of funding that will be available from the business. This can involve preparing financial projections for the business to determine how using business cash flow to fund the transfer will affect business operations.

- Quantify the owner's ability to finance a portion of the transaction. If seller-financing is used, the client should be advised about securing his notes, and how his interest may be subordinated to other lenders.

- When insurance is part of the plan, the practitioner should help the owner compare different types of policies (e.g., term vs. whole life or level premium or first-to-die vs. last-to-die). The owner must also decide who will own the policy and how the premiums will be paid.

- Assist in obtaining commercial financing by locating potential lenders and preparing a financing proposal.

- Address the possibility of making a public or private offering of equity in the company. If that is an option, the owner should be advised about the steps that must be taken before an offering can be made.

Plan for Ownership Succession

Transfers to Family Members Transferring ownership to a family member (often a child) raises many issues because of the family relationship. Emotions that are not present when dealing with unrelated parties usually impact the owner's decision-making process. practitioner should be able to help the owner address the following issues:

- Dividing ownership between active and inactive children. Some owners want to divide their interest in the business among all children equally, even though the children may be contributing different amounts of time and effort to the business. It is often better to transfer other assets to the nonactive children. For example, consider using life insurance to provide assets for inactive children.

- Helping active children acquire an interest in the business. Often, the child or children acquiring an interest are named beneficiary of life insurance on the owner's life, so proceeds can be used to purchase the interest. Typically, life insurance trusts are established to keep the proceeds out of the decedent's taxable estate. A split-dollar arrangement can allow the business to pay some or all of the insurance proceeds.

- Understanding the implications of transferring ownership to inactive children. If inactive children own a controlling interest, they can undermine the actions of the active children. However, transferring a minority interest to inactive children may leave them with a nonmarketable, non-income producing asset since the active (majority) owners are not compelled to make distributions or provide the inactive children any other compensation.

- Determining whether a buy/sell agreement is appropriate, and if so, which provisions will achieve the desired economic and tax results.

Transfers to Nonfamily Members Although the family issues are not present, planning for ownership succession is still important. Often, the business is transferred to nonfamily members when multiple owners exist and desire to buy each other's interests rather than to admit "outsiders" as owners. Issues when ownership is transferred to nonfamily members include:

- Determining appropriate provisions in a buy/sell agreement if the business is co-owned.

- Locating a purchaser when no ownership successor is apparent. Sometimes, key employees are willing and able to complete a purchase. Other times, an outside buyer must be found. Because the owner often must finance at least a portion of the sale, and may rely on other payments from the business (e.g., non-compete or consulting), it is critical that the buyer's ability to successfully run the business be evaluated.

Identify Options for Transferring Ownership

Once the successor has been identified, the owner's need for cash has been quantified, and potential funding sources have been located, the planner can identify options for transferring the business interests. Options include gifting; selling or redeeming the owner's interest; selling business assets; and tax-free split-offs. Whether a transfer option will accomplish the owner's goals depends on (a) the owner's need for assets from the business, (b) the owner's willingness to incur tax on the transfer, (c) the successor's desire to be insulated from business liabilities, (d) the successor's desire to reduce future income taxes on the business, and (e) the amount of cost and complexity the parties are willing to incur. Also, factors such as the availability of funding and type of business entity affect the outcome of each transfer option.

Integrate Succession Plan with Estate Plan

Estate planning involves transferring an individual's wealth to his heirs while minimizing transfer (i.e., estate and gift) taxes. It also includes planning to ensure that the estate has sufficient liquidity to pay taxes and expenses without forcing a sale of the decedent's assets. Thus, there is clearly an overlap between a business owner's estate plan and succession plan. Many traditional "estate planning" techniques are useful for transferring interests in the business to the owner's heirs at a reduced transfer tax cost. These include:

- Using an annual gifting program.
- Forming a family limited partnership.
- Transferring business interests to a grantor retained annuity trust (GRAT).
- Selling the business interests to an intentionally defective irrevocable trust (IDIT).
- Transferring the business interests in exchange for a private annuity.
- Selling the business interests in exchange for a self-canceling installment note (SCIN).

Develop Implementation Strategy

As discussed earlier, developing a succession plan almost always requires a team of professionals. Thus, actually implementing the strategy requires communication and early identification of the necessary steps and who is responsible for each. The importance of the role of the team's coordinator cannot be overemphasized. The authors believe that the tax practitioner's knowledge of the tax consequences to all parties involved as well as his or her often in-depth knowledge of the owner's and the business' financial situation make him the ideal "quarterback" for the team.

Communicating the Results The authors recommend communicating the recommendations resulting from the succession planning engagement to the client in a written report. A well-prepared report effectively documents the planning engagement and provides the client with a personalized action plan. When a written report is used, the authors recommend that it be designed to accomplish the following objectives:

- Assemble and summarize client data.
- Reiterate client goals and objectives.
- Communicate planning decisions and recommendations.
- Provide an implementation action plan.
- Document the planner's analyses and findings.
- Educate the clients to understand the plan.
- Provide the basis for continuing client service.

Client Data Client financial data, either in summary or detail, is accumulated as part of the engagement and typically appears throughout the report. The financial data is included to summarize or to support the recommendations in particular sections of the report. For clarity's sake, a brief summary of selected data, put near the front of the report, helps focus client attention quickly on the key elements of the current financial situation.

Client Goals The client's business succession goals should drive the engagement (i.e., progress toward attainment of those goals is the purpose of the engagement). Therefore, it is important that the report clearly restates the client's goals. The restatement of the goals refreshes the client's awareness and provides him with a framework to comprehend the effects of the planning decisions and recommendations in the report.

Recommendations A good business succession planning report should clearly and specifically convey the decisions and recommendations developed during the engagement. One purpose of the engagement is clearly communicating a game plan to lead the client toward the achievement of his goals. Some planners scatter recommendations throughout the report; however, if the planner centralizes the recommendations in the report, there is less chance for miscommunication. For maximum clarity, the authors suggest that the recommendations be cross-referenced to the goals they are intended to address.

Client Action The planner wants the client to act on the plan. Therefore, one purpose of the written report is to encourage the client to act. However, complex presentation inhibits client understanding and thus discourages client action. When a business succession planning report is presented to the client, the authors suggest including a separate, simple, concise action plan in the report.

Documentation One purpose of the report is to document the planner's analyses and conclusions. In most engagements, particularly those involving complex issues or multiple conclusions, the documentation is best split into two parts: (a) a narrative summary in the body of the report and (b) detailed supporting data and analysis in the report appendix material. The narrative summary briefly explains the calculations and other analysis work followed by the planner's conclusions. Detailed supporting data and schedules, placed at the back of the report in an appendix, serve to document the relevance and soundness of the planner's analyses and findings. The client, or other advisers who may use or contribute to the report, can use the detailed supporting data to the extent necessary. The details are provided for documentation purposes and are to be placed at the back of the report so they will not interfere with the client's focus on the summary findings and recommendations in the body of the report.

Educational Materials In general, a clear, succinct report restricted to essential data will be better received and more effective than a complex, lengthy report filled with boilerplate language that tries to educate the client on the intricacies of planning strategies and techniques. Client educational materials, if deemed necessary, are best placed in an appendix to the report. Some planners prefer to give the client the educational material at a separate meeting lest it distract him from the essential purpose of the engagement or overwhelm him by its volume.

Continuing Services In addition to documenting the engagement and giving the client a plan of action, the report serves a marketing purpose. This is another reason report arrangement and appearance are important. They can greatly affect the client's acceptance of the report and the engagement. Being asked to provide continuing services (and to collect continuing fees) is more likely when the client likes the report; in one sense, it is the only "product" the client sees. The key to client acceptance is presenting a report that is clear, concise, and personalized in its presentation of essential client data, planner analysis, and a plan of action.

Design a Contingency Plan

Succession plans are usually designed to accomplish the client's goal of transferring ownership and management responsibility to the successor during the owner's lifetime. However, a sound succession plan must also provide a contingency plan in the event an owner's premature death or disability forces a transfer before the intended successors are ready.

The contingency plan answers the question "What would happen to my family and the business if I am not there tomorrow?" Because it is planning for the present, it must be monitored and updated as the owner's situation changes. For example, the contingency plan for an owner with very young children and a wife uninterested in the business might be to sell the business at the maximum possible amount to provide funds for the family. As that owner's children grow older and show interest in the business, the contingency plan may evolve into transferring management responsibility to a key employee and ownership into a trust until the children are ready and able to take over. Clearly, the practitioner should periodically review the contingency plan with the owner to determine that it reflects the owner's and business's current situation.

As far as the business is concerned, the contingency plan must identify the person(s) who would assume management responsibility if the owner were suddenly unavailable. Often this is a key employee who is already very familiar with and involved in making management decisions. If the owner has a child that may someday be able to assume management responsibility, the plan may call for an interim manager until that child is ready. In that case, the plan should also include a way to objectively determine if and when the family member is ready to take over.

The contingency plan should also provide for the owner's family in the event he or she dies or becomes unable to work. Typically, this is accomplished as a part of the estate plan and includes deciding whether or not the business should be sold, and who is to become the owner if it is not sold. It also includes providing liquidity to the estate and heirs. This is usually accomplished by planning to reduce or defer estate tax and by purchasing life insurance.

Critical steps for designing a contingency plan are:

- Review the owner's will to ensure that business ownership is transferred appropriately in the event of his untimely death.
- Determine the family's liquidity needs in the event of the owner's untimely death or disability.
- Identify possible interim managers if the plan is to wait until children (or other designated successors) are prepared to assume management responsibility.
- If the business has multiple successors, consider a buy/sell agreement that addresses ownership succession in the event of any of the owner's deaths. Review any existing agreements to ensure that the result of a triggering event fits the owners' needs.

MONITORING AND ADJUSTING THE PLAN

Planning should be an ongoing process. The plan is normally based on the client's goals as of a particular date. Many variables can cause these goals to change.

The ideal way to keep the plan current is to monitor it on a periodic basis. The frequency with which update meetings are scheduled varies with clients' needs and their ability and willingness to pay for the updates.

Some planners see the client on a regular basis, such as at tax return preparation time, and the planning update can be easily scheduled then. When client contact does not otherwise occur at regular intervals, the authors recommend a periodic communication with the client, which serves a twofold purpose: (a) it keeps the planner's name in front of the client as a reminder that he is ready and willing to be of service, and (b) it provides a vehicle to alert the planner of any significant change in the client's family relationships, economic situation, or family condition that might trigger the need for updating the exit strategy. Such changes often result in new or revised goals. Sometimes a meeting with the planner is necessary for the client to focus on his goals and determine whether his existing plan continues to meet his needs.

In addition to changes in the client's personal, business, or financial condition, external factors, such as changes in tax laws, create the need for periodic communication to reassess the client's succession plan and perhaps redefine his goals and objectives. Appendix 1J is a checklist that can be used to monitor changes that might impact the client's succession plan.

OVERCOMING RESISTANCE TO SUCCESSION PLANNING

Although it is easy to understand the importance and benefits of having a succession plan, the fact is many owners fail to plan. In fact, many statistics indicate that a majority of business owners do not have a plan for the business after their death or retirement. This pervasive failure cannot be attributed solely to a lack of knowledge, but must instead indicate that significant emotional issues are preventing many owners from implementing a business succession plan. Practitioners must be aware of these issues and be prepared to deal with them if they are to be successful in helping clients design and implement a succession plan.

Owner's Reluctance to Let Go

One of the most frequently encountered barriers to succession planning is the owner's reluctance to let go. There are a number of reasons why the owner may be reluctant to relinquish control of the business. The key to overcoming this reluctance is to identify the underlying reasons for its cause and develop a plan for alleviating the owner's concerns. Some of the reasons an owner may not want to let go are addressed below.

Retirement Concerns The business is often a focal point of the owner's life. The thought of relinquishing control may trigger a number of emotional responses. Often the owner has spent so much time and energy building the business that he neglected to develop other outside interests. He may fear being bored or feeling useless or unimportant without a leadership role in the business. To help alleviate these concerns, practitioners should encourage owners to develop outside interests which may include hobbies such as golf and tennis or increased civic or charitable activities. Hopefully outside activities will help reassure the owner that there is life after the business and alleviate his concerns.

Financial Security Concerns The business is often the major source of income for the owner. Owners may be wary of relinquishing their control over this income stream. They may avoid the succession planning process because they feel it will reduce their future financial security. These concerns can often be overcome by providing the owner with retirement and financial planning projections that confirm the adequacy of the owner's retirement resources, including funding received as part of the ownership transfer.

In addition to their concerns about the adequacy of their retirement resources, many owners worry that the successor will mismanage the business and jeopardize their remaining interest in the business. The owner will often retain an income-producing interest in the business to help fund his retirement (e.g., installment note, debentures, etc.). The owner may be reluctant to become dependent on the successor. Hopefully, a well-designed management succession plan that includes a personal development program for the successor will alleviate these concerns. Otherwise, the practitioner may need to devise an ownership succession plan that terminates the owner's interest in the business at the appropriate time.

Loss of Business Identity Many times the business is the owner's source of identity in the community. Owners take pride in the way their business is perceived and are often recognized for the contributions the business makes to the community. They may fear they will lose this public identity if they transfer control of the business. Practitioners can help alleviate these concerns by developing a succession plan that instills the business philosophy in the successors and ensures that the business will continue to promote the family in a positive manner. Also, the owner's family could consider establishing a foundation to support charitable causes in a way that would provide recognition to the owner.

There are numerous other reasons the owner may be reluctant to relinquish control of the business. Planners should anticipate the owner's reluctance to let go of the family business and address these concerns at the start of the business succession planning engagement. In some instances, the planner can alleviate the owner's fears. In others, it may be advisable to bring in an outside family business consultant to try and soothe the owner's concerns. However, planners need to recognize that some owners may never let go, making it impossible to devise a lifetime succession plan. In these instances, it is imperative to devise a succession plan that addresses the needs of the family and the business after the owner's death.

Unwillingness to Confront Family Issues

There are an unlimited number of conflicts and emotional issues that can exist in a family business. For the most part, these conflicts are the result of the overlapping goals of the family and the business. Unfortunately, the succession planning process often surfaces many of these conflicts and emotional issues. Thus, many business owners avoid succession planning to avoid confronting these issues. The following is a discussion of some situations where conflicts and emotional issues commonly arise.

Unqualified Children Many owners recognize their children are not qualified to run the business. However, they are often unwilling to tell the child he or she is not capable of running the business for fear of damaging their family relationship. Thus, the owner may postpone succession planning to avoid the conflict that may result by telling the children he does not believe they are qualified to run the business.

Evaluating Children Based on Their Merits Most families treat their children equally regardless of their unique abilities. The children are accepted based on their status as members of the family. Successful businesses must evaluate their employees according to their talents and abilities. Succession planning often forces business owners to evaluate their children on the basis of their business skills and abilities. This process often generates a great deal of resentment among the children and may damage family relationships. As a result, business owners may resist succession planning in order to avoid the conflict created by evaluating their children according to their business abilities.

Choosing between Children In addition to forcing owners to evaluate their children on the basis of their merits, succession planning often requires owners to choose a management successor from among their children. Then, potential for conflict is high even when the logical choice is apparent. As with any business, those who are not chosen for advancement often blame the decision-maker and resent the worker who got the promotion. Unfortunately, when the employee who did not receive the promotion is also a family member, these emotions can strain family relationships. Understandably, the owner may resist succession planning in an attempt to avoid the conflict that may result when he names a management successor.

Competition among Siblings Children often compete for their parents' favor. To a certain extent, these rivalries are unavoidable. Unfortunately, such rivalries often intensify in a family business environment. Although a certain degree of competition is healthy and often serves to motivate the children, it can also get out of hand, generating unproductive competitions that can hurt the business and permanently damage family relationships. As a result, many owners defer the succession planning process because they fear it will lead to unproductive competition among the children.

Dividing the Wealth Parents usually attempt to treat their children equally when dividing their wealth. When the bulk of their estate consists of a family owned business, it is often difficult to divide equally. This is especially true when only some of the children are active in the family business. In these instances, it is often prudent to leave the business interest to the children who are active in the business to minimize the risk of undue interference from their siblings. Consequently, parents must design a plan that achieves a fair, if not equal, division of their property. This unequal division of wealth can create friction among the siblings if the inactive children feel they are not getting their fair share of the wealth. Thus, the owner may resist succession planning to defer making the tough decisions regarding the allocation of wealth.

Overcoming the Barriers to Succession Planning

Family and business goals tend to overlap Although these goals are not mutually exclusive, they are certainly different and often competing. For example, while the family goal may be to provide continued employment and job security for family members, the business goal is usually to maximize profits. These goals may conflict if the family members involved in the business do not have the talent and motivation to perform their jobs.

Assessing Family Goals and Relationships Because of the potential conflict between these goals, a logical starting point for a business succession planning engagement is to identify the goals of individual family members and those of the business. Often, this process will include an analysis of the family members' relationships with one another. Identifying family goals and relationships enables the practitioner to uncover potential issues that may become barriers to the succession planning process. These issues can then be addressed at the beginning of the succession planning process in an effort to resolve potential conflicts before they become obstacles to the succession plan.

Consequences of Not Planning Another way to overcome barriers to succession planning is to point out the consequences of not planning. From the business perspective, failing to plan for management succession puts the company at great risk. At best, the company struggles along for a couple of years until the successor acquires the skills needed to direct the business. More than likely, the lack of a competent leader will eventually lead to the demise of the business. As a result, the business that the owner spent a lifetime building fails due to inadequate planning.

From the family's perspective, a lack of planning may be even more disastrous. First, a business failure could jeopardize the family's financial security. In addition, relationships may be strained or permanently damaged as family members fight for control of the business operations and its resources. In both cases, the business that was the lifeblood of the family turns into an instrument of conflict and emotional strain.

Owners often avoid succession planning because it forces them to make difficult choices that may generate resentment or ill feelings among family members. They may not realize the additional hardships that will be imposed on family members as a result of their inaction. Practitioners should be sure the owner understands the ramifications of postponing succession planning. Many owners will proceed with succession planning when they realize the additional hardships that may be imposed on family members if the tough decisions are avoided.

Shifting the Decision-making Responsibility As previously discussed, an owner's reluctance to make difficult choices is a frequently encountered barrier to succession planning. This barrier can sometimes be overcome by shifting the decision-making responsibility from the owner to another individual or group of individuals. Typically, this means shifting the decision-making authority to the business's outside board of directors. However, the shift in decision-making responsibility is usually limited to items that impact business operations such as designating and developing a management successor. (Note that many family businesses do not have an outside board of directors. In these instances, it may be wise to consider forming an outside board as an integral part of the succession plan.)

Using a Family Business Consultant Many obstacles encountered in business succession planning engagements involve emotional issues and interpersonal conflicts. Although well-schooled in legal, accounting, and other financial skills, many practitioners may not be comfortable addressing the emotional issues that can become barriers to succession planning. For example, an owner may insist on naming a child as his management successor even though he knows the child is not capable of managing the business. Although this decision is not in the best interest of the business, the owner is reluctant to make the proper decision for fear of alienating family members. This reluctance puts the practitioner in an awkward position. If the practitioner presses the issue, he may jeopardize the client relationship. If he does nothing, the business may suffer. In these cases, it may be advantageous to bring in a family business consultant. These professionals are trained in the psychological and emotional aspects of family businesses and can be a valuable resource for resolving conflicts. In addition, it is often easier for them to take a tougher stance with the client since they do not have a continuing client relationship. Hopefully, they can help the client overcome barriers to developing an effective business succession plan.