Estate Planning to Make a Family Business Last Generations

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Topics: Business Ownership and Succession (https://www.retirementwatch.com/topics/business-ownership)
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Why do only 10% of family businesses reach the third generation? Perhaps one reason is that only 28% of family businesses have a succession plan. Yet, 40% to 60% of current owners say they want their businesses to stay in the family. Unfortunately, few have an Estate Planning (https://www.retirementwatch.com/ten-basic-rules-for-every-estate-plan) strategy to make that happen.

Estate lawyers and financial planners know that successfully passing on the family business is one of the most difficult estate planning problems. Despite what many people think, taxes are not the highest hurdle to keeping a business in the family. The tax issue can be dealt with in most cases if the owner begins planning in time and implements the estate planning strategy.

The psychological and emotional barriers erected by the owner are the key obstacle to a successful business succession. Most founding owners tend to have controlling personalities and will not cede or even plan to cede control of the business. In addition, the business often is viewed as another child and is protected to the same extent.

There are other emotional factors. The owner would lose power and many perks and could face a standard of living reduction or at least a change. Also, by preparing for a succession the owner has to acknowledge that he or she is not indispensable. In fact, the owner has to work to make sure he or she is not indispensable to the business. Owners also have to realize that changes are likely to be made that they wouldn't have made.

For a business to make a successful transition between different generations, two key decisions have to be made. First, the owner has to decide that he or she will leave the business and when that will be.

Ideally, the planning begins about five years before the owner intends to move on. This gives time to select, groom, and test the successor. It also gives family members time to get used to the new arrangement. A plan that avoids tax and other hurdles also can be developed and executed. The less time that is available, the less likely it is that the business will survive intact for long.

The second key question is how much wealth the owner will need to support his or her lifestyle. Founding owners often try a partial succession. They retain all or at least a significant ownership stake and preside as chairman of the board or some other position. The result is that everyone knows who still has the ultimate authority and there has been no succession. Of course, if the owner's lifestyle depends on continuing cash flow from the business, retaining control is understandable. But it prevents a succession.

The amount of financial support the founding owner needs could determine at least part of the succession plan. A need to have all or most of the business's value in cash will eliminate some strategies that would help keep the business in the family. Giving ownership to family members, even at reduced gift tax cost, would not be viable. Likewise, taking back debt or an annuity from family members also might not be viable. The family business would need enough cash flow to pay the obligation and support the new family member owners.

A successful transition also requires at least one family member who is able and willing to run the business.

The owner needs to determine the needs and goals of family members. One approach is to ask each family member to write a brief mission statement that includes his or her goals for and thoughts about the business. It also should include thoughts about working with other family members.

Once this work is done, the succession plan often is relatively easy. The financial needs of the owner probably will limit the choices of how the business ownership can be transferred. The interests and needs of the children and grandchildren also will eliminate some possible strategies. The estate planning advisor then can show the effects of using the remaining available strategies.

Founding owners should realize that one of their goals should be to make themselves dispensable. If the owner is indispensable, the business often isn't worth much to an outside buyer, and the children will have trouble finding a lender or investor to help them buy the business. I have seen many cases in which a buyer decided that a small business depended on its owner and wasn't worth much more than the value of the real estate it owned. If there was no real estate, then the value consisted of the wholesale cost of its inventory and a percentage of its accounts receivable.

It takes a tremendous investment of an individual's life to build a small business. Ensuring that business survives as a family enterprise requires the same amount of intensity and effort.

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