



Keeping it in the Family Keys to Succession Planning

by: Thomas E. Pastore, CEO

After pouring years of blood, sweat and tears into building your business, it would be a shame to lose it, fail to maximize your financial return, or fail to ensure its longevity after you are gone. As we will demonstrate in this article, a little bit of planning can go a long way!

Very successful business owners often overlook the need for succession planning. Whether you decide to retire or you are in the unfortunate situation where you or a business partner become seriously disabled or pass away, a succession plan can help ensure continuity for the business. Succession planning also can save your heirs from paying a hefty estate tax (up to 55%) to the government upon your death.

A solid succession plan addresses legal, managerial, financial and ownership issues. Depending on your goals and objectives, your succession plan may address a gradual transition in management and ownership beginning today, or it simply may define the process to be undertaken in a crisis whereby you no longer could perform your duties.

"Ask yourself if you have the right outside financial advisory team in place that can assist you in protecting your business and estate", recommends Fred Denitz, Regional Vice President of Mellon 1st Business Bank's Century City Office. With seasoned advisors, such as an attorney, commercial banker, CPA, insurance expert and business valuation expert, creating a succession plan is not as daunting a task as many anticipate.



Your succession plan may include a number of components, such as:

❖ **BUY-SELL AGREEMENT:**

If there is more than one shareholder, one of the most important documents you can have is a buy-sell agreement between the shareholders. A buy-sell agreement provides for the continuity of your business if a shareholder is disabled or passes away by structuring for the other shareholder(s) to purchase sufficient shares from you or your estate to operate the business. This can be especially important in a company with two owners, each holding a 50% interest. Without both votes, no decisions can be made. The agreement can include salary and distribution provisions to ensure that even a disabled shareholder is treated fairly. However, as Denitz points out, "It's critical that you have a way to fund this transaction between your partner(s) and your estate".

❖ **Life Insurance:**

A good way to fund a buy-sell agreement is for the company to purchase life insurance on each shareholder under which the company is the beneficiary. According to Denitz, "The company can use these proceeds to buy back your shares from your estate. This will create treasury stock and thus increase the percentage ownership of the surviving owner(s), ensuring that business-as-usual can continue."

❖ **KEY-PERSON INSURANCE:**

If you perform valuable services for the company, it may be difficult to continue operating the business in your absence. Key-person insurance, with the company as the beneficiary, can provide funds to retire bank debt, hire a replacement or fund temporary losses.

❖ **GROOM A SUCCESSOR:**

Prepare one or more people in your company to take over your duties in case of your retirement, disability or demise. Grooming your successor(s) is a long-term process, requiring a time commitment on your part. However, this is one of the most important parts of planning for the longevity of your business. An important goal of succession planning is to reduce the



value of your business ownership interest so that, upon your death, the beneficiary(ies) of your estate will not be burdened by a large estate tax.

Although recent legislation gradually phases out the estate tax by the year 2010, the tax will be reinstated in 2011 as it is written, and may be changed prior to 2010 by a new President or Congress.

As it is impossible to know when you are going to pass away without the help of a great psychic, you should assume that there will be an estate tax in effect upon your death. In addition, you should think about diversifying your investments as you approach retirement. Having nearly 100% of your net worth tied up in one company is very risky.

Methods of reducing the value of your estate and/or diversifying your investments while accomplishing the goal of having a solid succession plan for your company include:

◆ **ESTABLISH AN EMPLOYEE STOCK OWNERSHIP PLAN (ESOP):**

Selling shares in your company to your employees via an ESOP not only provides diversification of your assets with tax benefits, it can increase employee morale and can provide for management succession. "With an ESOP, you can continue your legacy while liquefying your investment. However, don't forget to establish a funding source to enable the ESOP to purchase your shares", stated Denitz.

◆ **GIFT SHARES OF THE COMPANY:**

By gifting minority interest shares of the company to your heirs, you can take advantage of minority and marketability discounts on the valuation of the shares. Hence, you can reduce or eliminate the taxes associated with the gift(s).

◆ **ATTRACT FRESH EQUITY:**

You may be able to attract equity capital into your business in exchange for a piece of the pie. For growth businesses, equity investors not only can provide a way for you to diversify your net worth, but their deeper pockets and knowledge often can increase your company's growth-rate.



◆ **INCENTIVE COMPENSATION PROGRAMS:**

By offering an incentive compensation program that incorporates stock options or Phantom Stock, you will be able to attract key managers as well as retain your management, sales, and product teams. "Many of our customers in very competitive industries have used this method to attract key employees from larger corporations", stated Denitz.

◆ **SELL THE COMPANY:**

When you're ready to retire or exit the business, you may want to think about selling to a strategic or financial buyer. However, you must be aware of the long lifecycle required to sell a business and the tax implications associated with the purchase structure.

Taking action today to prepare for retirement, disability or death is an important part of keeping your business healthy and preserving wealth in your estate. In order to maximize your goals for your company and your estate, both financial and otherwise, you need to understand the value of your company and net financial returns under the various options, as outlined above. For example, by instituting an ESOP, you can end up with significantly higher net proceeds than an outright sale of your company, despite a lower valuation, due to the tax benefits.

SP&H can value your company under various assumptions to help you determine which path has the potential to maximize your return on investment and sweat equity.

For more information on how to structure a solid succession plan, please contact Tom Pastore at (310) 571-3400 or tpastore@sphvalue.com. To discuss the many financing options available to liquefy your life long investment in your company, please contact Fred Denitz at (310) 788-9500 or denitz.f@mfb.com