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Business Succession Planning

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This article provides information and describes issues relating to business succession planning by business owners.

CREDITOR PROTECTION PLANNING
A successful succession plan includes protecting a business owner's assets from unanticipated lawsuits and liabilities. Business owners should avoid situations in which their personal net worth is at risk. This occurs when a business operates as a sole proprietorship or general partnership and where commercial real estate is owned in an individual's name.

Good planning includes the conversion of sole proprietorships and partnerships to LLCs or LLPs and the transfer of commercial real estate to an LLC. LLCs protect assets not owned by the LLC from liabilities arising from the LLCs business activities. Thus, the use of an LLC can create a "liability firewall." For tax purposes, LLCs are preferred because they are taxed as partnerships or sole proprietorships.

FACTORS AFFECTING SURVIVAL OF BUSINESS
Several factors can affect whether a business will be successfully transferred to its successors. Inadequate estate planning is a factor that occurs when owners fail to keep their estate plans current. Inadequate retirement planning is another factor that occurs when owners have not worked out a personal financial plan that allows him or her to withdraw from the business and maintain the desired lifestyle. Inadequate management and ownership succession planning becomes a factor when owners fail to designate who will succeed them and to prepare the successor.

Family Issues. Family issues can often be the heart of the planning process. This can occur when some members of the family are active in the business while others are not. Additional family issues can arise through personal rivalries, poor intra-family communication and an owner's inability to relinquish control.

Management Issues. Addressing management issues is crucial to a successful succession plan. In order for any business to be successful, it must have effective managers. Succession planning includes designating and training a successor and retaining key employees. It can also include the treatment of family and non-family employees on an equal and fair basis.

The failure to identify and consider important factors that could affect the survival of your business and certain issues inherent in your succession plan can produce unfortunate consequences. These consequences often include a poorly structured and impractical business succession plan, poor personal retirement planning by the business owner and the payment of additional estate taxes. Business owners need to rely on experienced advisors to help them manage the considerable risk that is present in the succession planning environment.

BUY/SELL AGREEMENTS
If, for family or financial reasons, the succession plan does not allow the owner to give the business to the successor, setting up a "buy/sell" agreement should be considered. Nearly all business owners that have a partner should have a buy/sell agreement. This is an agreement for the purchase and sale of a business interest on pre-arranged terms upon the occurrence of specified events such as death or disability.

Having a well-drafted buy/sell agreement helps address several problems. The problems addressed include:

- No public market for the business interest
- Lack of diversification of assets
- No control over who partners will be
- Uncertain pricing and payment terms

Under a cross-purchase buy/sell agreement, each co-owner has the primary duty to purchase the other co-owner's interest.

Under a redemption agreement, the business has the primary duty to purchase a deceased or disabled owner's interest. There are significant tax consequences to the owner and the business based upon which type of agreement is used.

Most buy/sell agreements must be funded with life insurance to provide cash to purchase a deceased owner's interest. It is difficult, if not impossible, to replace a deceased business partner; however, having the cash to purchase the deceased owner's interest greatly increases the likelihood that the business will survive the untimely death of an owner and key employee. Life insurance is a fundamental component of buy/sell agreements because it provides liquidity and is widely available and reliable.

SALE OF BUSINESS
The business succession plan often includes the sale of the business. The sale of a business process typically includes these steps:

- Pre-sale planning and valuation
- Negotiating letter of intent
- Due diligence by buyer
- Negotiating definitive agreement
- Closing procedure

SELLER FINANCING
Many business sales include the seller taking back a promissory note for a significant portion of the purchase price which will be paid over several years. This may allow the seller to defer recognizing gain for income tax purposes. The terms of the installment obligation are a significant component of this transaction. Payment terms, collateral security and protection in the event of default must be thoroughly considered.

AVOID ESTATE PLANNING MINEFIELDS
Generally, business owners should avoid these poor planning results:

- Lifetime guardianship
- Post-death probate
- Payment of estate taxes

Guardianship. Guardianship is a state-imposed system designed to protect a person under a disability. While in general this is a good system, there are many undesirable aspects to a guardianship including loss of privacy, additional costs and fees and additional personal stress. These can be avoided through well-drafted financial and health care powers of attorney.

Probate. Probate is a state-imposed process in which a court has authority over the transfer of a deceased person's property and the payment of their creditors. Probate includes disclosing personal and financial information, additional administrative expenses and delay. To avoid the problems of probate, business owners should utilize revocable living trusts as their primary estate planning document, rather than a Will.

Estate Taxes. The Economic Growth and Tax Relief Reconciliation Act of 2001 provides meaningful tax relief in the estate planning area. However, the relief is provided under an increasingly complex set of tax laws. Under the Act, there is a gradual phase-out of the federal estate tax over nine years until a full repeal in 2010. However, in 2011, all estate tax laws that were in effect in 2001 become effective again resulting in the estate tax laws coming full circle back to where they were when the gradual repeal was enacted. Complicating this situation was Wisconsin's recent enactment of a state estate tax that provides an exemption amount less than the federal exemption amount. The Wisconsin estate tax is vague and subject to many interpretations. It can result in a Wisconsin estate tax being imposed when the entire estate passes free of any federal estate tax. All provisions in estate planning documents aimed at minimizing estate taxes must be reviewed and drafted by experienced estate planning attorneys.

Estate Planning. A good business succession plan includes a well-drafted individual estate plan for the business owners. Most business owners should have these documents as part of their individual estate plans:

- Revocable trust
- Will
- Living Will/Medical Directive
- Health Care Power of Attorney
- Financial Power of Attorney

The estate plan must also properly incorporate life insurance and retirement plan beneficiary designations.

Business succession and estate planning is essential and unavoidable. Failing to do the necessary planning creates considerable risk for the business owner's family, co-owners and employees. Business owners must implement and maintain a succession plan. This requires the development of a continuing relationship with an experienced estate and business planning attorney.
