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Succession Planning Options for Family-Owned Businesses

by Chris Hamilton, CPA, CFE, CVA, DABFA

Last month we addressed the estate and gift tax planning issues related to the Duncan estate. This month, we will address the significant succession planning issues presented by the facts of their case.

Typical Scenario: The Duncan Family
The Duncan family is typical in several respects. Jim and Liz have worked almost a lifetime together to build a business, a family, and a comfortable life. They have achieved all of it as represented by their 4 children and 11 grandchildren (so far) along with a successful business, a beautiful home, and a very comfortable retirement. Jim is still active in what he calls "the family business." He continues to work for several reasons – he loves it and he feels that he needs to protect his investment. He has also determined that he is not comfortable handing the business over to his management team. None of his children have shown any interest in working in the business either now or in the future. The business has grown to be quite successful and it provides the cash flow that supports the comfortable life for the Duncans. There have been several offers to buy the Duncan's business over the years but Jim has never really considered them because he has always wanted to keep the family-owned business in the family for the sake of his children and his grandchildren.

There are several issues presented by the scenario of the Duncans. Some of them are:

- The "family business" really is not a family business! Other than Jim, none of the family are involved in the operations of the business – although they are all likely reaping the fruit (profits) of the business.
- There are no obvious buyers for the company that would allow Jim to stay involved.
- Jim obviously wants/needs the business – it is his source of work and cash flow.

These points are obvious but are highlighted because they are so common and "typical" in dealing with owners of closely-held businesses. The ultimate problem is that the Mr. Duncan will probably hold onto the business and once he is gone (death or disability) there will be a crisis in the business that will result in the demise, sale, or weakening of the business. These results are inconsistent with the desire of the Duncans – that the business stays in the family.

What Can Be Done?
There are several options available to the owner to address these concerns:

1. Sell the business – This puts Mr. Duncan in control of the timing and direction of the asset known as the family business. It converts the illiquid asset into cash, a note, or a combination of the two. It provides him the greatest control over the distribution of the assets. In my experience, while this is the most rational option, it is the least utilized because of the ongoing desire to hang onto the family business.
2. Replace management with future owners – This option requires significant time and risk depending on the health and longevity of Mr. Duncan. It is a step that is much easier said than done.
3. Get over the hesitation, and begin the process of selling/transferring ownership to current management.
4. Begin to sell/transfer ownership to family members with an understanding that they will be owners and not part of management.
5. Ignore the entire issue – This is all too often the decision.

In all the options discussed above, the owner must have an understanding of the value of the business and a willingness to engage an attorney experienced in the orderly transfer of a business. The business appraiser should be knowledgeable of estate tax valuations as well as have transactional experience.

Options 1 through 3 require transactional experience and knowledge. Option 4 requires knowledge and experience in valuing for purposes of estate and gift taxes.

Options 2 and 3 will require the development of a buy-sell agreement that lays out the process of valuation and orderly transition of ownership and operating control upon the death, disability, and retirement of Mr. Duncan. This will compel coordination between an attorney and the valuation expert.

Averting a Crisis
Depending on the value of the family business, there is great motivation to avoid the coming "crisis" in the business. Teamwork between the owner, the attorney, and a business valuation expert will minimize the probability and impact of those future events. That Mr. Duncan is leaving the business is not a question. The only uncertainty is the timing and impact of his departure.

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