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With four specific services, The Center provides complete unbiased planning. The Center does not sell any products; its main purpose is to provide advice. Local experts are retained to implement the plans developed by the Center. The Center for Financial, Legal & Tax Planning is located at 4501 W. DeYoung Street, Suite 200, Marion, Illinois 62959. Phone 618-997-3436; Fax 618-997-8370.

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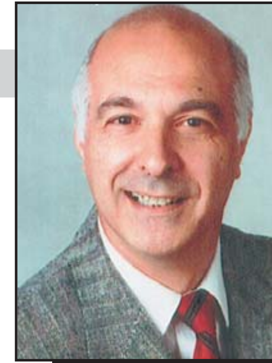

Bart Basi

Step One of Business Succession: Choosing a Successor

In our previous article, the topic of business succession was discussed. Continuing on the topic, and going from the general to the specific, choosing a successor is discussed herein.

Human life is finite; the life cycle of a business is potentially infinite. Choosing a successor is critical to the survival of any business and can be critical to accomplishing your goals as well. Making the right choice means your business survives and the wealth that the continuation it brings will continue to benefit you and your family. On the other hand, choosing the wrong successor can mean financial ruin, not getting paid for the sale of the business, or worse. Knowing the basic types of successors is empowering to make the right decision in transferring your business. Transfers of business interests including gifting, selling to family members, selling to employees, selling to competitors, or selling to investors are discussed below.

Gifting the Business

In transferring a business interest, one option that exists is that of gifting the business. Typically the individual to which the interest is being transferred to, may not have the money to buy the interest. The intent of a transfer like this is to avoid or reduce estate and gift taxes, make smooth transitions from one generation to the next, or both.

Transfers to a person are limited to $12,000 per year per person in order to be tax-free. Amounts beyond this amount are taxed according to applicable tax rates. However, with the use of the Unified Tax Credit, no actual gift tax may be charged.

In addition to this goal, business owners often desire a smooth transition of the business to the next generation. When the business owner passes away, typically an estate with the business included, will be in a state of disarray. Since the business interest is removed early in a gifting situation, it essentially escapes the effects of the shock and grief when the owner's dies.

While gifting seems to be simple and effective, certain inherent problems exist with gifting as opposed to an outright sale of the business interest. One problem that does exist is business valuation. Year-by-year business entities will grow or contract. Being that there is expansion and contraction, the value of the gifted portion will vary as well, creating, in essence, a moving target.

Another problem, transfer of the business is not completed all at once in gifting situations. If the transfer is not completed by the time of the demise of the transferor, estate and control issues will arise. For the intended successor, holding a minority interest coupled with lack of control leaves the successor in a precarious position. While the successor can own part of the business and is responsible for the debts, the successor will not have the appropriate control to utilize and save the business. The author recommends gifting only in limited situations. Most estate planning and business succession scenarios are better planned through methods other than gifting.

Selling to the Next Generation

Another way, and probably the best way, to transfer a business interest is to sell the business interest. This strategy is followed when the goal of the business owner is to ensure a smooth transition and to obtain a value in return for the business. The effect of the transfer will not reduce the value of the estate as gifting the interest does because cash is exchanged for the business.

Typically, either stock or assets of the company will be sold to the successors. When selling stock to the successors, capital gain will result to the seller usually in the amount of 15% until 2010. When selling assets, both capital and ordinary gain will result. Asset sales result in ordinary gain to the extent of depreciation taken on the assets over the course of their in service use.

In most business succession scenarios, this is the best route to take. In selling a business interest, ownership is well defined from the point of sale. The value of the business is also frozen in time at the point of the sale, negating the need for a year to year valuation of

the business. Business sales also cannot be reversed or contested as in the case of a written will or even gifts in some cases. The sale provides family members with a smooth transition that is definite in nature and is highly recommended in many business succession and estate planning situations.

Selling to Employees

When a business owner does not have heirs or even a single successor who is interested in the business, the option of selling or transferring the business to employees becomes appealing. There are four primary ways in which a business owner can transfer interests to employees. They are installment sales, stock options, bonus agreements, and phantom stock agreements.

Unlike selling to a family member, selling to employees brings different risks. Employees and business owners will typically have different goals and different experiences and knowledge. When the two parties conflict, making a transition can be risky for both. Defaults are common occurrences and the remedies can require legal action. While inferior to interfamily transfers, employee purchases to competent and reliable employees can greatly increase survivability of the business and payment of the obligations over time.

Selling to a Competitor

Another option that exists is that of selling to a competitor. Selling to a competitor is best when the seller wants to get out of the business entirely, yet receive a high price for the business. When a business is sold to a competitor, a covenant not to compete will be created, barring the former owner from competing against the new owner.

The sale can be done either through an asset or stock sale. If the owner chooses an asset sale, typically the buyer will pay more because they will be able to use certain deductions that only an asset sale allows. If stock is sold, typically the business owner will get less because deductions useable under an asset sale are not usable under a stock sale.

Risks are certain to happen here as well. The best advice, know the competitor and his or her reputation with business and money!!

Selling to Investors

Selling to a group of investors is yet another option. This option really only exists for larger, more lucrative businesses with good management in place. Investors are typically not interested in small, “mom and pop” type businesses. For larger businesses that choose this option, it can be quite lucrative. Investors typically see the business to be bought, not as a moneymaking entity, but a moneymaking investment. This different logic can result in higher prices paid for the same business.

Most risks are removed from the seller at the point of sale because promissory notes are typically not used unlike most other business sales. Businesses sold to investors are typically sold for cash and completed at a closing, allowing the parties to then pursue their own interests without fear of any further risks.

Conclusion

There are options available for your business succession paradigm. Whether you choose to gift the business, sell the business to family, or a third party, arriving at a course of action is critical. Without a course of action to pass on a business, rarely do businesses survive and rarely is value preserved. If you haven’t engaged in business succession planning or chosen a successor, be sure to call the professionals at The Center to begin your planning.

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