Business succession planning

Strategies for increasing the value of your business and positioning it for the future

More than one quarter of family-owned businesses expect to change hands in the next five years. Almost half of them do not have a succession plan in place.

As a business owner, you know the importance of planning ahead. Spending the time *now* to develop a succession plan can help you:

Increase current value of the business. A solid succession plan makes a business more attractive to potential buyers and may result in more favorable terms from banks on financing arrangements.

Establish financial security in retirement. Research suggests that only 18% of small-business owners participate in 401(k) plans, and many sacrifice personal savings in order to continually invest in their businesses.

Provide for family members. In the event of disability or premature death, a succession plan can help ensure that family members have access to cash or liquid assets.

Minimize taxes and efficiently transfer wealth. Estate taxes and other costs can take their toll — and often cause businesses to fail — without a proper plan in place.

Benefits of early planning

Successfully transitioning a business is directly correlated to how early you begin planning. Research shows that business owners who began planning for their succession 10 years ahead of time had an 85% success rate while planning two years or less resulted in only a 25% success rate.*

Planning now can help you beat the odds†

Small businesses that survive to the next generation:

30%

Small businesses that survive to the third generation:

12%

Use this guide to explore methods for building out a succession plan, including ways to:

- Implement a successful strategy
- Determine your successor
- Assess the value of your business
- Structure a deal

Learn about:

- Buy-sell agreements
- Family Limited Partnership
- IDIT Trust
- Grantor Retained Annuity Trust

* BluePrint for Business, Family Business Succession Planning, 2009. Most recent data available.

† U.S. Small Business Association, March 2010. Most recent data available.

Implementing a successful strategy

Determine your successor

Business partners. Selling the business to your partners can provide continuity with customers and other key associates, but a sale in the open market may be more lucrative.

Family. Transitioning within the family has advantages as well as challenges. Consider whether family members have the proper skills to operate the business, whether you will need to facilitate wealth transfer to family members or children who won't be affiliated with the business, and how the transition may affect non-family key employees.

A third party. An outright sale of your business could be the most valuable transaction, but it may negatively affect relationships with key customers and business contacts.

Employee stock ownership plan (ESOP). Transferring ownership of a small business over time to an ESOP can be an effective method for creating liquidity for business owners while rewarding employees. If structured properly, it can provide significant tax benefits as well.

Assess the value of the business

Take a broad overview. Before looking at cash flow, revenue, or other financial data, consider how a potential buyer may perceive your business based on other variables. Does your current customer base offer potential for future growth? How would an ownership transition affect the client retention rate? Is your revenue stream consistent and dependable? How stable and appealing is the overall structure of your business — location, employee base, operations?

Financial valuation. Consider using a market comparison or income method to determine the current value of your business and to make improvements that may increase that value.

Business valuation methods

Market comparison

This method measures earnings or revenue valuation based on recent transactions. While this method is easy to understand and communicate, most businesses are not identical, and a unique business or service model could make market comparisons difficult.

Income method

The income method applies a discount rate to determine the valuation of the business. A discount rate is used to calculate the present value of future cash flows. This may be a better representation of the business's value for buyers, who typically invest based on expected future cash flows. However, it can be difficult to objectively determine the appropriate discount rate — which is critical to the calculation.

Valuing a business using income method. The valuation can vary dramatically based on the discount rate used. The higher the discount rate, the lower the valuation.

	Cash flows	10% Discount	20% Discount
Year 1	$450,000	$409,090	$375,000
Year 2	600,000	495,867	416,666
Year 3	800,000	601,051	462,962
Residual value	8,000,000	6,010,518	4,629,630
Firm valuation		**$7,516,526**	**$5,884,258**

The calculation assumes hypothetical cash flows for three years and a residual value of future cash flows based on the Year 3 cash flow of $800,000.

How to determine a discount rate for a small business

Start with a risk-free investment rate. What type of return could you generate if you invested in a Treasury bond, for example, rather than in the business itself?

Add an equity risk premium. What could you earn by investing in a broad equity market?

Consider adding a small-cap premium. What could you earn by investing in a broad range of small-cap companies?

Adjust according to subjective factors. Consider your brand, clients, recurring revenues, staff, market share, patents, or intellectual capital.

Structure the deal appropriately

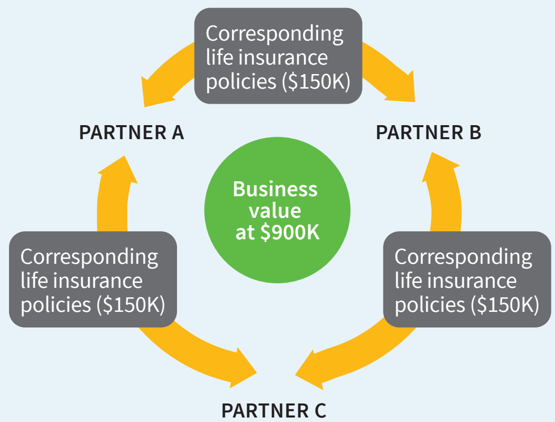
In structuring the transition, consider whether the purchase will involve cash, equity, notes, or a mix of assets. You may want to initiate performance triggers based on growth and client retention. It is also essential to explore the tax implications for both buyer and seller. You may consider an installment sale to spread out the taxable gain. Also, certain elements of a business may be taxed differently to the seller and buyer. For example, accounts receivable is taxed as ordinary income to the seller while the buyer receives this asset tax free as part of the transaction. For other items such as customer lists, the seller may receive more preferential tax treatment. This should be considered as part of the negotiations on structuring the deal.

Key estate planning strategies to transfer wealth efficiently include:

BUY-SELL AGREEMENT

- Legally binding agreement for transfer of ownership when one owner exits
- Can prevent foreclosure and enables remaining owners to maintain control
- Typically funded with life and disability insurance
- In the event of death, provides much-needed liquidity to beneficiaries of deceased owner
- Typical models include cross purchase and stock redemption
- A cross-purchase arrangement involves business partners purchasing life insurance on each other with proceeds used to buy out the interest of the deceased partner

A cross-purchase buy-sell agreement provides liquidity



FAMILY LIMITED PARTNERSHIP (FLP)

- Enables business owners to create two types of ownership shares, general and limited; name themselves as general partners; and transfer ownership of limited partnership shares
- Through a gifting strategy, senior family members can transfer the value of their assets to children and grandchildren, removing the assets from their taxable estates
- An FLP can bring significant gift- and estate-tax savings
- Gifts of limited partnership shares are typically discounted to reflect *lack of marketability* and/or *lack of control;* this can help accelerate transfer in value while avoiding or mitigating federal gift taxes
- Transferring ownership of shares can result in shifting income from taxpayers in higher brackets (original owners) to family members in lower tax brackets
- Provides asset protection since many states prevent creditors of a limited partner from attaching partnership assets

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Key estate planning strategies to transfer wealth efficiently include:

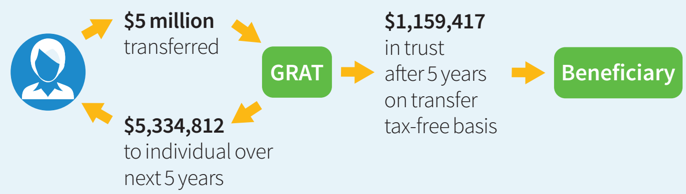
INTENTIONALLY DEFECTIVE IRREVOCABLE TRUST (IDIT)

- Typically established by the buyer of a closely held family business
- Structured in order to be valid for estate planning, but defective for income tax purposes; i.e., the trust is not recognized by the IRS as a separate taxable entity
- Depending on the IRS interest rate and appreciation of shares in the trust, assets may be transferred to beneficiaries free of gift and estate taxes
- Because the trust does not have to pay taxes, more assets remain for potential appreciation
- Taxes are paid by the business owner, therefore reducing the owner's taxable estate

GRANTOR RETAINED ANNUITY TRUST (GRAT)

- Can be funded with a range of investments, including ownership shares in a business
- Over the term of the trust — typically 2 to 5 years — annuity payments are executed from the trust back to the grantor based on the value of the assets initially transferred to the trust and the prevailing IRS interest rates
- At the end of the term, if assets have appreciated more than the IRS interest rate, the remaining value is transferred to beneficiaries free of gift and estate taxes

A GRAT can transfer wealth free of gift and estate taxes



Example assumes a five-year GRAT term based on an IRA section 7520 interest rate of 1.8% (as of November 2016).

Spending the time to develop a succession plan can help you improve the value of your business, position you financially for retirement, maximize tax efficiency, transfer wealth, and ensure that your business thrives into the next generation.

It is critical to work with a team of experts to construct a plan that suits your business. For more information on building a succession plan, talk to your financial representative or legal advisor.

This information is not meant as tax or legal advice. Please consult with the appropriate tax or legal professional regarding your particular circumstances before making any investment decisions.

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