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American Institute of Certified Public Accountants. Communications Division, "Succession planning for small business owners: A Speech for CPAs to deliver to general audiences" (1994). *Guides, Handbooks and Manuals*. 231.

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SUCCESSION PLANNING FOR SMALL BUSINESS OWNERS

A SPEECH FOR CPAs TO DELIVER TO GENERAL AUDIENCES

No. 890677

October 1994

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My topic for today is succession planning for small business owners. As a certified public accountant, this is an important part of my practice.

Small business owners have a lot to think about in their day-to-day affairs. What will my sales be next year? What will my expenses be? How will I retain competent employees? Who are my competitors? Is my technology up-to-date? There comes a time, however, when the small business owner must make some critical decisions about the long-term future of the business. These decisions are not just for his or her tenure as owner but for future owners as well. In other words, who will run the business after the present owner dies or retires?

Unfortunately, it's my experience that many small business owners don't give this crucial question a sufficient amount of attention until it's too late. Because the owner is usually embroiled in the day-to-day affairs of the business and in "putting out fires," the small business owner rarely has time to reflect on the long-term strategic plan for ownership of the business.

On the other hand, large businesses in America are making plans for just such future events. They want to be sure that regardless of the future of key individuals, the business will continue on a profitable course. The Wal-Mart company was well prepared for its transition. When Sam Walton died, the business didn't skip a beat. In the same way, it's even more important that small business owners make plans for succession. They are usually even more dependent on one, two, or three key people than is the large business.

In my experience I have found that there are two things that are mostly likely to destroy a small business: Under-funding and under-planning. Funding, of course, is not my topic today, but planning is.

Succession planning, in particular, is crucial. It can often determine whether a business will remain viable in the transition from one generation to the next. Statistics from the Wharton School of Business show that two out of three small businesses do not survive the transition from the first to the second generation, and that 85 percent of small businesses do not survive the transition to the third

generation. There are, of course, many reasons for this phenomenon and I would like to discuss a few with you today.

One of the largest threats to the successful transition of a business is federal and state death taxes. Death taxes are generally imposed on the assets owned by a person at the time of death. If you think income taxes are significant, wait until you hear about the death tax rates. The highest federal death tax rate is 55 percent. It is imposed around the $3,000,000 level of an estate. The lowest federal death tax rate is 37 percent, and it is imposed on a $600,000 taxable estate. By contrast, income tax rates range from a low of 15 percent to a high of 39.6 percent.*

The estates of most business owners consist primarily of the value of their business. At the owner's death, the business must be valued and tax will be imposed on that value. Needless to say, the law books are full of cases in which the IRS and taxpayers have debated the value of

*Rates accurate as of October 1, 1994

a business. Of course, estates take the position that a business has a relatively low value, and the IRS argues that it has a high value. People who plan are much more likely to get the better of the IRS on this issue, or to avoid the argument entirely.

Regardless of how this argument comes out, it's almost a certainty that a business owner's survivors will be forced to pay significant death taxes on the value of the business. There are some relief provisions in the tax code which allow for payment of part of the taxes over extended periods, but for the most part, the tax is due and payable within nine months of the owner's death. In many cases, if there is not sufficient cash to pay the tax, the heirs are forced to take on a substantial debt load in order to satisfy it.

This tax liability is one reason why businesses are threatened when an owner dies. Think of it as though your business had a huge debt payable to the bank nine months from the date of your death. The business would have to scramble to refinance this debt and would face a significant burden in doing so.

The worst part about this scenario is that in many cases, all or part of death taxes are avoidable by using some relatively simple planning techniques. This is where your CPA comes in. Formulating and implementing an effective tax plan may be crucial to the survival of your business.

Taxes are just one reason why businesses do not successfully make the transition to the next generation. Another reason is poor business planning.

When a business owner dies or retires, many questions need to be answered. Who will run the business? How is it to be financed? Who will take over the duties of the departed owner? How will customers, vendors and employees be satisfied that the business will be run as efficiently as in the past? Issues like these are very difficult to address all at once. Therefore, when the owner dies, if no plan has been made for a smooth transition, there is often a great deal of confusion. During this period, customers may drift away, vendors may become nervous, and employees may start printing their resumes. Would you

want to do business with a company that is in a state of confusion? This is why it is critical that your business make a plan for succession.

Again, your CPA can help you understand many of the issues that might face the business on death or retirement.

Because every business is different, it's hard to say just what a succession plan should be. However, at a minimum, a good succession plan should deal with the following:

1. Keeping death and transfer taxes to a minimum.
2. Finding a way to place control of the business in the hands of a person who has the inclination and ability to successfully run it.
3. In order to preserve family harmony, there must be a way to satisfy the heirs of the owner who do not receive part of the business. That is, they will need to share in some other asset.

4. The plan needs to address the needs of employees, creditors, customers and vendors. As I mentioned a minute ago, employees and customers can become especially vulnerable when the business leader exits the scene.

5. The plan should take into account the needs of the retiring owner. The owner should be prepared psychologically as well as financially for the transition. Therefore, to ease the owner's concerns, it should be demonstrated that there will be sufficient income to fund retirement and that the owner will be able to enjoy his post-business life. This might even include seeing that the owner has something to "retire to" such as a hobby or charitable work.

6. The plan should prescribe criteria for entrance into the business. For example, a prospective manager could be required to have a certain level of education or business experience.

7. The plan should address the best way to select successors. Family members are a good choice, but only if they have the expertise and experience to be effective managers. Usually, the next best choices are trusted employees.

The succession plan should take into account the various personalities in the business owner's family and find a way to address each member's needs. The family needs to understand the reasons for the business plan and how decisions were made. The family should understand that everyone's interests are served by pulling together to make the plan work.

The CPA can play a valuable role in this process. Because the CPA is independent and objective, he or she may be able to help the family members see the benefits of the plan. The CPA can serve as a facilitator in bringing the family into agreement that the plan should be pursued and implemented.

Now that you know that a succession plan is a good idea, what do you do next?

Unfortunately, what many business owners do is nothing. If death taxes have not been addressed, this "do nothing" plan may send the business into unexpected debt. Also, the business itself may go into turmoil. One of the worst consequences following the departure of a strong family leader is a struggle among family members for control of the business. This happens sometimes in large companies, but is especially prevalent in small companies. With no plan, each heir may believe he or she is the best suited to run the business. By the time each side gets their own lawyers and fights for control, the business has often eroded to nothing. What is worse, the turmoil of the business is usually no secret. Competitors quickly learn of a problem in a business and move to take advantage of it. A business where family members are fighting is the most vulnerable.

If you are convinced the "do nothing" option is a poor one, some typical business succession plans should be considered. These are not

"one size fits all," but they attempt to combine sound tax planning with a way to transition the business.

One option is to sell the business to the family owner with the most interest in the business. For example, if a business owner has three children, he might sell the business to his daughter who is interested in the business. By doing this during his lifetime, the retiring business owner may also be able to provide himself with a retirement income. In addition, the money provided by the sale makes an easy asset to divide among the owner's other children. Best of all, this permits a smooth transition of the business to the daughter, a person who has interest and experience in the business. By the time the business owner is completely out of the picture, the customers, vendors, creditors and employees will have become used to the new owner and their loyalty will be to her.

Another alternative is a gift of the business to the family members involved in the business. If properly structured, a gift or series of gifts can move the business out of the owner's estate at a minimum

transfer tax cost. Some recent IRS rulings have made this approach much more attractive by permitting minority discounts for business interests even in family situations. For example, if a parent gives 10 percent of a business to a child, the 10 percent can be assigned a low value for gift tax purposes because it is a minority interest. Therefore, the transfer can be made at a lower tax cost. In the past, the IRS opposed this type of valuation among family members, but has now conceded the issue.

A more complicated option is to sell or give the business to several family members. The advantage of this method is that it tends to treat family members equally. Also, this plan allows the business owner to take advantage of some recent favorable tax rulings. However, it is the trickiest plan to pull off because control issues have to be addressed.

When a business is sold or given to a group of siblings, the inevitable question is: Who will be the boss? Democracy works well for countries but badly for small businesses. The difficulty is in picking a

strong leader without destroying the family. The current owner should not simply give away or sell the business to family members. Instead, the owner should impose a plan which designates one or more leaders of the business. The other siblings are much more likely to accept the guidance of the older generation on this topic.

Often times, there simply is no family member who has the interest or ability to run the business. In this case, the business owner may want to consider a sale of the business to an outsider, either during his or her lifetime or at death. An obvious advantage is that this provides cash liquidity to the owner's estate. The estate then contains an asset which is very easy to divide among the heirs: Money. This plan should help you avoid family conflict. Also, when a business is sold, some significant tax planning opportunities are available.

The problem with this plan is that family businesses are often not very marketable. Because small businesses do not trade openly, at sale they often bring very low prices. For example, depending on the industry, one might expect to see prices of six to ten times earnings

paid for a small business. Public companies may sell from 20 to 30 times earnings or more. This means that the family can usually earn much more money by running the business than by selling it and reinvesting the proceeds in an alternative.

Remember, it's usually not a good idea to simply provide in a will that the business be sold at the owner's death. The will is a public document and this may provide competitors and bottom feeders a chance to take advantage of the situation.

If a sale doesn't make sense and there are no family members interested in the business, another option is to retain professional management for the business. In other words, if the business owner won't be around to run the business, hire someone to do it. Because good professional management is very costly, this usually only works in larger family businesses. Also, even professional management must be overseen. So the business owner still needs to address who among the heirs will control the business and control the professional management. The major advantage to this approach is that it allows

the business to continue and can be a good investment for all family members.

If I have convinced you that a succession plan is a good idea, you may be wondering what your next step should be. First, you need to develop a picture of where the business is today. Suppose you were to die or retire right now. What would be the tax consequences to the estate and your heirs? In order to determine this, you will probably need to estimate the value of the business. Your CPA should be able to help you with this process. He or she understands the financial end of your business and is often trained in valuation techniques. I find that an initial projection of death taxes often spurs clients to take action when they learn exactly what the numbers are.

The next step is to identify whether there are family members who are likely successors as owners of the business. Obviously, any children who are already in the business are good candidates. It is often a good idea to get the advice of outside parties who are familiar with the business. Again, your CPA can help you here because he or she has

probably observed the business for some time and may be able to help you identify the right person to run the business.

After you have identified the "target," formulate a plan for moving the business to the next generation. The plan should take into account both tax issues and business management and control issues. For example, you may want to make annual tax-exempt lifetime gifts of voting stock to the child who is running the business and non-voting stock to the other children. You get the most bang for your buck when the business is aggressively valued, using the latest IRS rulings. Of course, this is another area where your CPA can help you immensely.

The final step is to come up with a structure for the transition of the business and a management plan for its operation when you are gone. This will usually involve your estate planning documents as well as shareholder and other control agreements.

Now that you have a succession plan, how do you make it a success?

First, I think you should involve the next generation in most of the decision-making. Your children or other heirs will be much more comfortable with a plan in which they have participated. Also, you may learn something from them in your discussions.

Second, as a rule, I recommend that people try to avoid having both active and inactive business owners. In other words, there should not be a class of "managers" and a class of "investors." The problem with this structure is that active business people usually want to reinvest profits in the business while passive investors are usually only looking for a cash return. Passive investors almost always think that the active business people are overpaid and under-worked. If this situation is unavoidable, the business plan <u>must</u> take into account a structure to address this issue.

Third, it is very important that your CPA and other business advisors be a part of the plan. Usually, in addition to your CPA, you will need your attorney, insurance and financial advisors. When you are so close to a situation, hearing from objective third parties is critical.

Fourth, I suggest that you look for opportunities to involve family members in the business if they are not already. Many business owners find it is very hard to let go of control and responsibility, but if a business succession plan is to work, this is crucial.

The last point in a successful business plan is periodic review. Don't allow the plan to sit on the shelf. It should be a living plan and should be re-examined at intervals to be sure it still makes sense and that it takes into account the latest facts and tax law.

In conclusion, I think the best advice I can give you is to plan ahead and plan early. As CPAs we see all too often situations where business owners have failed to plan properly, resulting in either a tax disaster, a family dispute, or both. The tax system clearly rewards those who get started with planning early and penalizes those who don't.

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