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Business succession planning made easier

Key steps business owners should follow

If you're thinking about developing a succession plan for your business, you're probably realizing already that there is quite a lot to consider. We developed this checklist for you to use as a guide during your planning sessions with your advisor. It should help you feel more prepared and stay better organized throughout the process.

Important things to know as you begin

What is business succession planning?

Business succession planning is a process that helps you develop a comprehensive plan for successfully exiting your business. It takes into consideration:

- Personal issues
- Financial planning issues
- Income tax issues
- Estate planning issues
- Life insurance issues
- Legal issues

What are the consequences of not having a business succession strategy?

- You may undervalue the company and receive less than full value
- You could overpay capital gains taxes
- Family harmony may be compromised
- Employees could endure uncertainty and may leave
- You won't have control over the exit process
- Your personal, financial and other goals for yourself and your family may not be realized

Step 1: Set goals and objectives

- Determine when you will want to leave the business
- Identify the key stakeholders (e.g., family members, co-owners, vendors, key employees and customers) and determine the impact of the exit on them
- Employ a multidisciplinary succession strategy team: a lawyer, a financial planner, an insurance professional, a CPA and a business valuation expert
- Match the manner and timing of the payment for the business to your post-exit financial needs
- Develop a post-exit income and estate plan; save on taxes but don't leave yourself without assets

Step 2: Determine the fair market value of the company

Short of engaging in arm's length negotiations with an actual buyer, there isn't one precise way to determine the value of the business. There are several recognized ways to value a business, and they normally involve the judgment of a professional valuator.

- Professional valuation by a business valuation expert or CPA
  - Can be costly
  - Often time consuming
- Some life insurance companies provide business valuation estimates
  - Not a formal valuation
  - Starting point for planning for succession

At Nationwide®, we can provide an informal estimate of your business value. There's no charge for this service, but we're able to run valuation estimates only for businesses with a minimum of $2 million in annual sales or $500,000 in book value. To get started, request our business valuation fact finder.

Step 3: Consider possible exit and succession options

A number of exit and succession options are available, and the appropriate choice depends upon your personal, business and financial goals, as well as the goals of other stakeholders.

Transfer to family member

Creating a successful family business succession plan requires focusing on how it will impact the entire family, especially those who have an active interest in the business. There are three transfer techniques to consider for family members:

Outright gift

- Can you afford to gift the business?
- What are the gift-tax implications?
- Be careful of giving family members passive interests in the business, as they may be more trouble than they're worth. Some common passive interest concerns are:
  - No income
  - Cannot sell
  - Waste of time and energy

Gift of interest in trust

- You need to place the business interest in a trust
- You, as the owner, retain a fixed or variable income interest
- A remainder interest goes to family members at the end of the income period
  - The present value of the remainder interest is a gift
  - If the interest in trust outperforms the government discount rate, this results in gift-tax savings

Sale to family members

- Business owners and family members enter into a buy/sell agreement, often funded by life insurance
- If the sale takes place during the business owner's life, the cash value of the policy can serve as a down payment, with the rest of the sales price paid as installments
- If it is a sale at death, the death proceeds cover the purchase price

Sale to nonfamily members

For a variety of reasons, transfers to family members sometimes aren't practical. When a transfer to a family member doesn't make sense, consider selling the business to someone currently involved in the business or a competitor looking to grow.

- Sale to co-owners — you may want to use a life-insurance-funded buy/sell agreement
- Sale to management — consider a leveraged buyout with a bank loan or an installment sale, or self-funded over a period of time with life insurance
- Sale to a third party — this could incorporate a bank loan or could be owner financed

Step 4: Decide how to fund the buy/sell agreement

	Strong points	Trade-offs
Bank loan The buyer would borrow money from a third party (or the business) and then use it to purchase the shares from the seller.	• Lump-sum payment	• Based on economic factors, loans may not be available when needed • There will be interest and other transaction fees
Installment sale Payments of a set principal amount plus interest at a specified rate are promised to the seller over a certain period of time.	• Provides a stream of income • Works well with family sale	• No lump sum available if needed • Interest costs and possible gifting concerns if interest isn't charged • Dependant on buyer's business success
Sinking fund Money is set aside in an account where it accumulates with interest, and a loan is taken at death for any amount needed to cover a purchase amount shortfall.	• Simple to administer • Lump-sum payment	• Will it be fully funded when needed? • Variable investment returns • Possible supplemental loan needed with associated costs
Life insurance Life insurance is purchased in an amount needed to complete the purchase of the business and possibly help with other needs.	• Money available when needed • May serve multiple long-term planning needs	• Insurance expense is added cost • May need to adjust as business grows

More on the role of life insurance

- Business succession planning involves preliminary consideration of certain common life insurance needs regardless of the exit option chosen. They include:
  - Preserving the value and salability of the business
  - Maintaining family harmony
  - Rewarding key employees
  - Making certain the business owner will be paid
  - Providing estate liquidity
- Make sure that the death benefit equals the purchase liability
- Consider high-cash-value policies as a source of down payments in the case of a lifetime sale
- Consider high-cash-value policies as a possible supplemental retirement funding source
- Consider disability insurance and long-term care riders
- Regularly review the coverage to make sure it keeps pace with the value of the business

Other important insurance considerations

Key-employee insurance

- What will happen to the value and salability of the business if a key employee dies or is disabled?
- Estimate the lost revenue, additional expenses and cost of finding a replacement if a key employee dies
- Purchase life insurance on the key employee to insure against loss

Key-employee compensation

- What will happen to the value and salability of the business if a key employee learns of your exit plans and leaves?
- Consider creating a golden handcuff to keep a key employee with the business during the transition period (using an IRC § 162 bonus plan, a restricted bonus plan or a deferred compensation arrangement)

Income replacement

- Are family members and key employees going to lose their jobs as a result of the sale of the business?
- Can those being displaced find new and equal employment opportunities?
- Consider providing immediate or deferred annuities for those being displaced

Estate equalization

- Do you want your heirs to share in the estate equitably?
- Are there heirs who do not want or should not receive an interest in the business?
  - Avoid giving passive interests in the business
- You could use life insurance to equalize the estate
  - The life insurance does not have to exactly equal the value of the business interest

Estate liquidity

- Will your estate be liquid after the sale?
- Does your business comprise a large portion of your estate?
- Do you want liquid assets to be used to cover transfer taxes?
- Consider setting up an irrevocable life insurance trust

You're sure to have questions throughout this very important process. As you do, please contact your insurance professional for assistance.

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