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Businesses don't pass successfully from one generation to another by accident. To put the "success" in "succession," business owners must develop succession plans.

Most don't bother – and it's no coincidence that most businesses don't survive past the original owner. The U.S. Small Business Administration found that only 30 percent of businesses continue into a second generation.

Without a plan, the unexpected death or disability of an owner can cause the demise of the business. Heirs may squabble over who owns the business and who should manage it. They may have to sell the business to pay estate taxes. And if non-family partners are involved, they may not treat heirs of the deceased fairly.

A succession plan should consider:

- An exit strategy
- Management
- Ownership
- Taxes

Failure to approach these issues carefully could result in failure of the company.

An Exit Strategy

The first step in succession planning is to determine who should control and manage the business when you leave, whether you leave voluntarily or involuntarily.

Business owners should develop an exit strategy as early as possible. Death or disability can make retirement plans moot. Having a plan in place can help the business continue operating, regardless of why a change in leadership is needed.

The following are among the ways to change ownership:

Keep it in the family. The U.S. Small Business Administration estimates that 90 percent of U.S. businesses are family owned, so it's not surprising that most owners leave their business to family members.

However, that works only if family members have the ability and desire to manage the business. The best way to find out is to involve them in the business. Experts advise that children work at other companies first, so they enter the business with experience and fresh ideas. They should learn the family business from the bottom up, and should be treated like other employees so they do not develop a sense of entitlement.
If several children are involved, do not give them equal authority and equal ownership. When too many family members make decisions, they rarely agree. Choose the best leader and even things out by leaving other assets to other children.

The owner should consider the liquidity needs of the business in case death or disability strikes before a planned transition. Life insurance is an excellent means to provide working capital to survive the loss of a key owner. The cash value may be used as a rainy day fund or to hire an experienced executive to run the business short term.
Finally, business owners should coordinate their estate plans and succession plans. Ownership of company stock, or membership interests in partnerships or LLCs, should be transferred to the owner's revocable trust during the owner's lifetime to avoid public probate of the business. The trust should dictate the ownership split of the stock to family members who are capable and willing to run the business.

Sell it to your partners. When there are multiple owners, a buy-sell agreement is needed to ensure that surviving shareholders have the first right to purchase shares of any owner who leaves.

The agreement keeps shares from unqualified heirs, disgruntled spouses and competitors. It also details how to value and purchase the interest of the person leaving, which is crucial to the success of the agreement. Typically, the company purchases life insurance, disability insurance or both on all owners, with the idea that the benefits or cash value from the insurance will be used to purchase the shares of the former owner. Two different structures are commonly used – the stock-redemption plan and the cross-purchase plan.

With a stock-redemption plan, the corporation is the owner and beneficiary of the insurance, and holds the cash value to fund the buyout. When a shareholder dies or leaves the company, the corporation purchases the stock and surviving shareholders are the only remaining owners.

The stock-redemption plan is simpler, but the cross-purchase plan has tax advantages. Using a cross-purchase plan, each shareholder owns an insurance policy on the life of every other shareholder. Upon death, a shareholder's stock receives a "step up" in basis to its fair value. The surviving shareholders purchase the stock with its stepped-up basis, minimizing capital-gains taxes when the company is sold. It also avoids the alternative minimum tax. When a stock-redemption plan is used, there may be no step up in basis for the surviving owners.

Business owners should consult with an attorney experienced in succession planning to avoid unintended consequences. For example, most businesses fail to review their loan documents to ensure that repayment is not accelerated upon the death of an owner or the transfer of stock. When overlooked, minor details can cause major problems.

Sell it to your employees. An Employee Stock Ownership Plan (ESOP), which grants shares to employees based on length of service and other factors, is ideal for a business with no family heir to take over, especially if there is not a strong market for selling the business. An ESOP can create a market for the owner’s shares, provide tax advantages, and motivate and reward employees.

Sell it to outsiders. While many people are reluctant to sell their business to non-family members, doing so can provide the owner with financial security and plenty of wealth to pass on.

Tax Issues

Many business owners find it difficult to transfer ownership to the next generation without incurring a tax bill so large the business has to be sold to pay it.

Without Congressional action, the top federal estate tax rate will increase from 45 percent next year to 55 percent beginning in 2011. The amount of assets exempt from estate taxes is scheduled to increase from $2 million today to $3.5 million in 2009 before dropping to $1 million in 2011. In addition, individuals can make gifts valued at up to $1 million during their lifetime without incurring gift taxes. Gifts valued above that amount are taxed at a rate of up to 46 percent.

Regardless of rates and exemptions, it is beneficial to transfer as much wealth as possible to heirs while the owner is living.

It is especially worthwhile to pass on shares in a family business, because the value of minority shares can be discounted. Since minority shares lack voting control, they cannot easily be sold and are worth less than majority shares. The IRS has ruled that such shares may often be discounted by 25 to 35 percent.

Many strategies are available to transfer a non-controlling interest to the owner's family, or in trust for the family's benefit, while minimizing gift taxes. A business owner should also consider opportunity shifting when starting a new business or an offshoot of a current business. By initially putting some of the ownership interest in trust for family members, the future value of the business will not create a significant estate tax burden.

Most business owners recognize that their business can't succeed without a business plan. They should also recognize that the business can't succeed through another generation without a succession plan.

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