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Business Succession Planning

1. **Business Planning Succession**

1.1 A business interest passes by law or contract, upon a triggering event, such as when the company is sold, or upon the incapacity, retirement, insolvency or death of the owner of the business interest.

1.2 Business succession planning is the strategy to implement a change in the ownership of business interests. The coordination of several documents is required to properly plan, including:

(a) Each owner's will and/or living trust;

(b) The company's governing documents (articles of incorporation, articles of organization, bylaws, operating agreement, or partnership agreement); and

(c) Buy-sell agreements.

1.3 Default Provisions: If the relevant documents are silent or conflicting, state law will govern, sometimes with court involvement. Owners should agree, in advance, regarding an owner's rights and the limitations regarding the transfer of business interests.

2. **Planning Objectives**

2.1 Basic Tools: There are a number of tools that can be used to plan for business succession.

(a) Wills/Trusts: If the primary objective is succession planning at death, a will or a revocable trust is essential to identify beneficiaries and the terms/conditions.

(b) Buy-Sell Agreements: One of the most popular planning tools for business interests is the buy-sell agreement. Sometimes the terms of a buy-sell agreement are incorporated into partnership agreements, limited-liability company operating agreements, bylaws, or other agreements.

(c) Gift-Giving: The most common way to shift business interests to family members is by gifts. Gifts of interests in a family business are usually entitled to valuation discounts because of lack of voting, control, and marketability. By making lifetime gifts, it is possible to reduce a person's interest to a minority share (especially for married couples owning equal interest), entitling the estate to a valuation discount for estate-tax purposes.

3. **Buy-Sell Agreements**

3.1 A properly designed buy-sell agreement should address the following issues:

(a) Triggering Event. A sale and purchase may be triggered by a number of events, such as an owner's incapacity, death, insolvency, desire to withdraw, or receipt of an offer to purchase from an outsider. The more triggering events that are addressed in the agreement, the less likely there will be a controversy.

(b) Obligation vs. Right to Sell or Purchase.

(1) A buy-sell agreement might provide that upon the occurrence of a triggering event, an owner must sell and the company/other owners must purchase the selling owner's interest. This is a mandatory buy-sell agreement.

(2) Conversly, an agreement may provided that only one party has an election to sell/purchase and the other party must abide by the election. For example, if an owner wants to sell to a third party, he is required to first offer the sell to the other owners/company for the same price/same terms, but only if they elects to purchase. This is referred to as a right of first refusal.

(c) Redemption vs. Cross-Purchase. An agreement may require the company to purchase the selling owner's interest (a "redemption") or require the other owners to purchase (a "cross-purchase"). Many agreements use both provisions, giving the other owners the right to purchase if they choose to exercise their right. If they do not exercise this right, the agreement may require the company to purchase the interests. The cross-purchase arrangement will increase the other owners' income-tax basis on their holdings whereas a redemption arrangement will not.

3.2 Insurance: Where a triggering event can be covered by insurance, such as disability or death, a buy-sell agreement should describe whether such insurance is mandatory or optional, how it is to be paid for, and how the proceeds are to be applied.

3.3 Price: Probably the most important factor in a buy-sell agreement is the method for setting the purchase price.

3.4 Advisors: The accountant should play a key role in developing a customized business-succession plan and buy-sell agreement by evaluating tax implications and cash-flow needs of the business and its owners. An appraiser is also essential in helping to determine the appropriate method for determine the price of the business.

4. **Conclusion**

Planning is essential for a smooth transition of a business/business interests. It is particularly important to consider the objectives of the business owner. For business interests passed at death, a will or revocable trust is a good starting point. Effective business-succession planning is not easily done without taking into consideration the many potential scenarios. It is important to involve an accountant and a business-valuation expert in developing the right plan.

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