Preserving the family business for future generations

Much of the attention surrounding the current financial crisis has focused on the implications for large businesses. Less emphasis has been placed on the impact that the turmoil has been having on family-owned enterprises.

Almost one in five small business owners is expressing concern about going out of business as a result of the economic climate, according to a survey conducted in October 2008 by the small business arm of American Express (American Express OPEN). It adds another entry to the list of enormous, ongoing challenges in operating a successful company.

The question to answer

For business owners who are approaching retirement, perhaps just as difficult a challenge is establishing a solid succession plan that will provide smoothly and effectively for the continuation of the business beyond the participation of its founders. The Small Business Administration estimates that only one-third of family-owned businesses will survive the transition from the first to the second generation. It looks even grimmer farther down the road: Other research suggests that only 12% of family-owned businesses stay viable into the third generation, and only 3% are alive at the fourth-generation level and beyond.

If you own a family business, as you plan to turn over the reins, the question to ask is: How can you transfer the business to your heirs, preserve the generation of income from the assets and provide liquidity, all with the least amount of tax erosion?

Elements of a succession plan

Many threads weave their way into the tapestry of a family business in transition. Specifically, you will need to:

- Determine the best form of operation for your particular business after you leave, whether it be a C Corp, S Corp, LLC, LLP or trust, considering all the tax and nontax issues;
- Divide the business fairly among your children, grandchildren and others who work in the business and those who do not;
- Review the business agreements among all owners (including nonfamily partners) that provide for buyout/cross-purchase of your interest at your death;
- Ensure that the valuation method for buyout purposes will be respected for estate tax purposes; and
- Draft documents (including wills, powers of attorney, trust agreements) that will give you the assurance that your plan will be carried out properly.

A family business is more than just an asset

As a business owner hands over the reins, it's not just the monetary issues that need to be addressed. The transition of a business may have underlying emotional components as well. Your business may stand as a symbol of a lifetime of achievement, both from a professional and personal perspective, evoking a strong feeling of pride and a strong desire to protect your legacy, even if you may be forced to make difficult decisions.

Your offspring may view the transfer of the business from two perspectives—as an heir automatically entitled to a share of the business (who had no active role in the business), or as someone whose talent and hard work has been instrumental in the success of the enterprise. An equal division of ownership, then, probably won't be welcomed by offspring who have contributed to the success of the business. Any other division may be viewed as inequitable by those who weren't involved in the operation of the business. In other words, there may be treacherous waters to navigate in order to avoid disharmony in the family.

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First, keep everyone in the family informed, whether they are involved in the day-to-day operation of the business or not. It's better to know about any hostilities upfront. In fact, springing the plans after everything is in place may well contribute to discord. An open discussion may help reveal reactions that may be addressed ahead of time.

Second, include the professionals—lawyers, accountants, insurance agents and trust officers—at the earliest stages of the process. They can provide useful planning insights and suggestions for the transition of the business.

Third, don't wait too long. Many professionals suggest putting a plan in place at least five years in advance of the time that you take that final walk through the door.

Finally, if the current economic environment has had an impact on your business, your succession plan is likely to reflect that fact. As the economy recovers, and your business improves, be ready to revisit what you have set in place to see if changes might be necessary.

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