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Introduction

The operational demands of running a family business or other closely held enterprise can be all-consuming, but it's vital that business leaders take the time needed to assess their organization's business succession planning. The penalty for failing to get ahead of leadership or ownership changes can be significant, as the coming years may bring substantial transfers of wealth as businesses change hands and adopt new ownership structures. The long-term survival of a business, and the preservation of the wealth that has been built, will likely depend on getting ahead of those changes through strategic succession planning.

For private, owner-managed, or family-owned businesses, a solid succession plan can drive the growth of the business, reduce taxes, and set the stage for retirement. Family-run businesses may benefit further by focusing on preserving harmony within the family.

This publication is a compilation of a six-volume series that addresses the broad range of topics that business owners need to consider in order to facilitate an orderly transition of management and ownership, including:

- How a strategic, long-term approach to business succession planning can help meet personal and business goals — and how to get started.
- How the choice of entity structure, valuation methods and financing options can impact succession planning — and outcomes — for private businesses.
- How management talent assessment, development and compensation planning can help solidify the next generation of company leadership.
- How planning ahead for estate and gift taxes, life insurance and investments can help address family and business needs and meet retirement goals.
- How to balance business needs and family concerns in order to create a long-term governance plan that can help the business and family prosper together.
- How adopting leading practices and strategies can help confirm one's legacy isn't left to chance.

Taken together, these issues demonstrate that succession planning is an important and evolving process. This is not a subject to be put off until later; to be done successfully, it needs to be an integral part of a company's business strategy and operations.

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Volume 1

The need for planning

A plan for permanence

No one goes through the work, risk, and sacrifice of starting a business without hoping it will last. Building value that endures is the dream that motivates entrepreneurs. Yet in many businesses, too little of that work goes into determining who will take over when the founders leave the stage.

According to the National Association of Corporate Directors, fewer than one in four private company boards say they have a formal succession plan in place.¹ There isn't a good reason to justify the common oversight of not planning for business succession. Some business leaders are too caught up in the challenges of the present. Some have a subconscious aversion to the reality that they won't be around forever, or assume succession will work itself out naturally. Others are aware of the task's true complexity and find it overwhelming. Ultimately, however, the reasons people avoid succession planning aren't as important as the reasons they should embrace it.

For a business, working without a succession plan can invite disruption, uncertainty, and conflict, and endangers future competitiveness. For companies that are family-owned or controlled, the issue of succession also introduces deeply emotional personal issues and may widen the circle of stakeholders to include non-employee family members.

The next 10 to 15 years may bring substantial transfers of wealth through business ownership handoffs across generations and other new ownership structures. The long-term survival of those businesses, and the preservation of the wealth they have built, will depend upon a clear and early focus on strategic succession planning.



¹ <http://www.nacdonline.org/AboutUs/PressRelease.cfm?itemNumber=4699>

Not so simple

Succession planning is a complex process that draws upon many business disciplines. Many privately held businesses display solid professionalism and enviable profits in their daily operations, yet fail to properly plan for and complete the transition to the next generation of leaders. Even the most sophisticated and knowledgeable business professionals can get caught in a web of complicated issues. In fact, many business owners do not carry out a managed transition to a successor leadership team. In the case of family-owned businesses, only 30 percent survive into the second generation, 12 percent survive into the third, and only about 3 percent operate into the fourth generation and beyond.

An owner-manager usually has a personal vision to retire and sell the business “someday,” but he or she may not have adequately considered what it will take to make that vision a reality. Even leaders who profess they’ll never retire have to acknowledge that no one remains at the helm forever.

An unprepared new management group, or even a poorly managed transition to competent management, can trigger significant loss in value. If leaders want their businesses’ intrinsic value to remain intact for the benefit of their successors, they should begin the planning process sooner rather than later. Many leaders choose to embark on a long-term program to identify and groom the company’s future executives. In some cases, a careful planning process may reveal that selling the business instead of maintaining successor ownership really is the answer for their situation.

Not all succession plans are created equal. If your business has a succession plan in place, the questions on the facing page can help determine how effective that plan and your current practices actually are.

The need for planning

Succession planning is a multidisciplinary process. When you engage in succession planning, you’re not just focusing on the future, because it’s impossible to plan for the future without a deep understanding of the present. Leaders have to know the current reality of their businesses — how they operate, where the value lies, what their needs are, who their most vital customers are and why — in order to prepare for new leadership and new structures that can provide continuity in the ways that matter.

There are many benefits for companies and owners who plan properly and strategically for an orderly transition of management and ownership:

- Survival and growth of the business or its assets — under the current structure or after sale or restructuring
- Preservation of harmony when the business is family-owned
- Reduction or elimination of estate and income taxes
- Facilitation of retirement for the current leadership generation
- Ability to retain control of the process instead of having someone else make decisions

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A multidisciplinary platform

If succession planning isn't as simple as some may believe, how can leaders make sure they're covering the necessary bases? An inclusive approach focuses on three categories of crucial components:

Family

- Goal articulation
- Family information and communication
- Estate and gift planning
- Life insurance analysis
- Investment advisory services
- Family offices

Shareholder

- Shareholder agreement
- Disability planning
- Compensation planning
- Stock transfer technique

Business

- Business strategy assessment
- Management talent assessment
- Corporate structuring
- Current business valuation
- Retirement planning

Considering these components is a useful way for business owners to conceive and implement a broad-based plan that can address critical needs and win acceptance from multiple stakeholders. By following this approach, business owners can also draw on the experiences of select advisors who work together as a team, enriching the plan's scope and effectiveness.

The owners of privately held businesses face complex planning issues. For some, the first order of business is the long-term success of business operations, which encompasses a host of distinct issues. For others, the priority is the preservation of family wealth through estate, gift tax, retirement, insurance and investment planning — an equally complex challenge that may not always align perfectly with the aim of perpetuating the business.

These issues should be part of a long-term strategic plan that accounts for the needs of the business as well as the needs of the business owner:

- Creation of a formal development program for likely successors
- Evaluation of corporate finance and entity structure options, including debt and financing paths
- The competitive landscape of your industry and business value drivers
- Compensation planning for successors and other executives
- Creation and implementation of shareholder agreements
- Contingency planning in case something interferes with the performance or availability of leadership personnel
- The complexity of closely held stock valuation issues, and efforts to limit the impact of those complexities on long term value
- Use of tax-effective ownership-transfer techniques

Strategic succession planning becomes even more complicated when family issues such as legacy, birthright, communication, personalities, and interpersonal dynamics are added to the mix. Even an apparently simple succession scenario can become more complex when family interests mingle with business concerns. Even without any explicit disagreement among those involved, the goals of the business — to generate profits, exploit market opportunities, reward efficiency, develop organizational capacity, and build shareholder value — can come into direct conflict with the recognized goals of the family.

Succession planning — a starting point quiz

Compare your status quo to the questions below. If one or more “no” answers reveal deficiencies in your approach, know that you aren’t alone — and that it’s not too late.

1. *Have you defined your personal goals and a vision for the transfer of ownership and management of the company?*
2. *Do you have an identified successor in place?*
3. *If applicable, have you resolved the family issues that often accompany leadership and ownership decisions?*
4. *Does your plan include a strategy to reduce estate taxes?*
5. *Will there be sufficient liquidity to avoid the forced sale of the business?*
6. *If succession will one day require the transfer of assets, have you executed a “buy-sell” agreement that details the process ahead of time?*
7. *Is there a detailed contingency plan in case the business owner dies or becomes unable to continue working sooner than anticipated?*
8. *Have you identified and considered alternative corporate structures or stock-transfer techniques that might help the company achieve its succession goals?*
9. *Have you determined whether you or anyone else will depend upon the business to meet retirement cash flow needs?*
10. *Have you recently had the business valued and analyzed in the same way potential buyers and competitors would?*

A good plan takes time to develop and implement. This study is an introduction to the questions you’ll have to ask as you start down that road. In subsequent editions, separate guides will look more closely at several of the important topics.

Translating a need into an imperative

Even when everyone agrees succession planning is important and necessary, reasons to delay the process have a way of sprouting up.

- No one is sure exactly whom to call for help or how to start.
- Leaders worry about being fair to potential successors.
- Leaders struggle to acknowledge those personnel whom they want to retain on the management team but who aren’t in line for ownership.
- Leaders have difficulty discussing financial matters and personal goals with others.
- The owner may not wish to retire.
- Leaders struggle to disconnect from the day-to-day urgencies to focus on long-term planning.
- Leaders are reluctant to commit to complicated strategies that may save taxes but don’t address their own non-tax goals and concerns.
- They don’t believe successors are ready to assume control, and so they feel nothing can be done.
- The entire process seems too daunting.
- Leaders perceive it is a cost that delivers no immediate benefit.

These anxieties help explain why so few private businesses have an actionable succession plan in place. Few business owners simply ignore the issue, but many may focus too narrowly on individual elements of a succession plan without taking on the full range of important issues. The result can be false security followed by a poor outcome for everyone involved.

These potential blind spots in long-term planning can cost business owners and families through lost future value as well as a hit to their legacy. An inclusive, multidisciplinary approach to succession planning can dramatically increase the chance for desirable results.

Aligning goals across time — and across roles

Taking the time to understand the factors that really drive a company’s continuity and growth can help owners and stakeholders create strategic priorities and develop a detailed action plan.

It’s common for leaders to think of succession planning in terms of the organizational chart — which people will replace which people. But it’s just as important to think of an organization’s operating structure and how it may change over time. What are the functional activities that must happen today? How will they be different tomorrow as the business grows? Will your customer base, suppliers, or product mix experience significant change? Only then can you turn to the question of which people will carry out those functions.

This exercise turns the organizational chart and operating structure from two-dimensional snapshots of “now” to three-dimensional representations that change along a time axis. An organization is constantly changing its alignment of people with operating requirements, and to do this, it should identify what competencies a role will require in the future and assess how individual team members progress toward acquiring them.

It’s also common for business leaders to think of succession planning as a high-level exercise. In some businesses, the plan may encompass only the top job. In this top-down, three-dimensional approach, however, succession planning extends to all levels of the business. Leadership, management, and business units all have succession issues to address. You may put more detailed effort into determining who will be the next CEO, but the business stands to suffer if you don’t also plan for who will succeed each department head, manager, supervisor, and significant team members.

There is a cultural component to predicting and managing these changes. Studying and analyzing an organization’s culture can help leaders see patterns and subcultures that have as great an influence on daily operation as any formal standards. The company’s culture is derived in part from the vision of what it is to become. Does a small or medium-sized business aspire to be huge? Or to maintain its size? Are there plans to go global? Variances in these and similar paths ask different things of people.

In making these decisions, privately held businesses often hold the advantage over large corporate structures. Leaders in privately held businesses have the knowledge and authority to make people-based decisions effectively. They know which people exhibit long-term leadership potential, regardless of their present-day level of training. They have the contact to recognize character and decision-making ability, and they are able to move with agility in rewarding it. Where a large corporation sees a business unit member, a private company may be more likely to see a whole person.

A systematic approach that takes all these questions into consideration can help important stakeholders identify and understand the most critical issues pertaining to the continuity and growth of the business. With that understanding, they can create strategic priorities and develop an action plan that addresses their myriad needs.

This exercise is designed to reveal the critical issues. The plans that arise as a result should align with the goals and common vision the owners and stakeholders have identified. An important first step is to compile and understand stakeholders’ goals and expectations, then to articulate a common vision for the future of the business.

Communication with stakeholders

Lack of clear communication is one of the biggest threats to a smooth transition of a business from one generation to the next.

Once you have identified critical issues, it’s important for the company to articulate the owner’s personal goals and vision for the future of the business, while also considering the needs and concerns of other stakeholders. That doesn’t mean everyone will get what he or she wants. But by including the stakeholders in the goal-setting process, owners and other relevant decision makers can operate from a wider base of information. They can encourage all parties to feel a sense of ownership in the succession plan. And they can greatly improve the likelihood that it will play out as they intend.

The goal-setting process

To set an array of interlocking goals, start with a definition of the desired end result. If your communication process has produced a vision for the future state of the organization that stakeholders support, that’s the end goal. Each intermediate step should be consistent with that vision and contribute demonstrably toward getting there.

A closely held business owner should consider not only developing goals for the business and establishing personal and family goals as well, including those related to an exit strategy, retirement, and personal lifestyle.

What are the characteristics of well-formed goals? The well-known mnemonic **SMART** makes it easier to remember them: Goals should be **S**pecific, **M**easurable, **A**ctionable, **R**ealistic, and **T**imely.

There are many questions that decision-makers should address early and often during the goal setting phase:

- Should the business owner keep the business or sell it?
- If the business is to remain within a family, who will lead it?
- Will the selection of a new leader create interpersonal acrimony?
- If the business will be sold, is the current operating strategy for preserving or increasing stakeholder value?
- For business owners who plan to sell their business in the future, what short-term actions could enhance the value of the business when a sale is executed later?

The goal-setting process allows owners and business leaders to identify and review the objectives for management and ownership transition, as well as to clarify the underlying business and continuity strategies. When drafting goals, consider the time frame and cost parameters for achieving each one. That is the first step in turning a wish into an operative plan.

Business strategy assessment

Business owners should account for the company's strategic direction when building a succession plan. In short: Where are you headed? What is the business planning to be or do that will make an effective succession worthwhile?

Many private business owners have already implemented a strategic planning process and developed written business plans. Others have either not undertaken this effort, or have not kept their business plans current and relevant. To better understand the importance of developing an overall strategy for the business, it helps to consider a number of general concepts.

What is strategic planning?

Strategic business planning provides an analysis of the business and its environment as it is today in order to create a formal program for guiding its development and operations tomorrow.

For closely held businesses experiencing growth, the strategic plan normally addresses a one- to three-year period, and often looks as many as five years into the future. Although the content of strategic plans varies considerably, the basic components include:

- **A mission statement.** A clear definition of what the business will be, the products or services it will provide, who will compose the customer base, and the primary purpose(s) for existence.
- **Goals.** Measurable statements of what the business will accomplish in areas such as growth, profitability, and research and development.
- **Strategies.** Broad initiatives that will be implemented to achieve specific goals.

Why undertake strategic planning?

Strategic planning provides the opportunity to create and position the business for competitive advantage in the future. In short, you can control the process or the process can control you. A sound strategic plan:

- Defines, in measurable and objective terms, what is important for the business to achieve.
- Anticipates problems and outlines positive steps to manage them.
- Builds commitment and orients senior management team members around a common purpose.
- Charts a clear direction and provides "marching orders" for the business and its employees to follow.
- Drives consistency in decision-making processes and effectively allocates resources, including people, equipment, and facilities.
- Establishes a firm basis for evaluating both corporate and individual performance.
- Provides a framework that management can use to speed responses to changed conditions, unplanned events, and deviations from the plan.

Who should lead strategic planning?

Select managers and owners of the business should assume responsibility for developing and executing the strategic plan. These individuals understand the business intimately. They recognize its potential and limitations. They can commit the resources required to implement plans, and they can initiate and monitor the steps that will drive implementation. They should oversee the formal analysis of the strategic planning data, reach the necessary conclusions, and commit the business to future courses of action.

This does not mean other internal resources or external consultants cannot or should not play a role in the strategic planning process. Indeed, both staff members and outsiders can offer invaluable perspectives in the development of a sustainable plan.

The following scenarios are based upon experience with actual family businesses. They are intended to illustrate the importance of goal setting, communication, and a holistic approach to succession planning.

Family feud

Robert is a closely held business owner in his early 60s. Two of his children, Nathan and Emily, are relatively inexperienced at working in the business, and a third child, John, does not work in the business at all. Robert wants to scale back involvement in the business so he and his wife can move away and enjoy their retirement years together. With outside help, Robert builds an estate plan that includes family partnerships and trusts that hold insurance and company stock. The family's perception is that the business succession plan is "complete."

A year later, Robert is ready to retire, but cannot because the siblings are floundering in their executive development. Robert relies more on non-family employees, who are not in line for ownership, to get things done. Nathan and Emily resent this. Meanwhile, John feels the salaries, company cars, and other benefits Nathan and Emily draw from the company are coming at the expense of his inheritance. When Robert finally does pull away, Nathan and Emily assert their leadership in the resulting vacuum despite their lack of preparedness. Several important executives and customers leave, sales fall off, and the top salespeople go to the competition. John wants Nathan and Emily demoted or fired to protect the value of the inheritance. Robert worries about the value of his stake as a source of retirement funding.

Months later, company operations continue to suffer. The children are no longer speaking with each other and holiday get-togethers are cancelled. John forces a sale of the business for cash, but the family receives only a fraction of the amount that financial advisors and attorneys projected years earlier in the estate plan. Taxes eat half of even that disappointing sum.

Nathan and Emily are not equipped to find similar high-level jobs elsewhere, and they struggle professionally. John blames Nathan and Emily for gutting his inheritance. Robert must revisit his post-retirement dreams. In the aftermath of the sale of the business, all the estate tax planning accomplished years before has been unraveled.

Analysis

Robert relied on specialists for sophisticated estate planning. Why did everything go wrong? In reality, estate planning is only one facet of succession planning. Robert made a plan for transferring enterprise value, but not one for continuing to generate or maintain that value. His approach to succession planning should have incorporated management talent assessment, compensation planning, stock transfer strategies, formal directorship roles for both family and non-family officers, corporate structuring, communication plans, and estate planning.

All goals are not created equal

Four unrelated partners — Anne, Carlos, Lawrence, and Brian — have worked together for decades to build a strong business. Three of them, Anne, Lawrence, and Brian, are in their mid-60s and intend to retire. Carlos is some 20 years younger than the others and feels strongly about keeping the business going.

The three retiring partners believe in the business. They genuinely want it to keep prospering with Carlos as CEO. However, they also want to monetize the value of their investments to fund retirement. An additional complication is that the group never envisioned three simultaneous retirements — everyone always assumed Anne would remain active for several additional years and spread the transition over time, but because of family medical needs she wants to sell and retire now.

Because of the company's current levels of capital, borrowing capacity, and risk tolerance, it is out of the question for Carlos to buy out all three of his partners and have anything left to operate with. Even if the retiring partners were to accept a reduced or deferred payout, the company would be left crippled.

Disappointed, but intent on preserving the value they've built, the four partners decide instead to sell the business rather than continuing it under Carlos's leadership. Everyone, including Carlos, receives the full present value of his or her stake in the company from the third party that buys and absorbs the company. But Carlos loses a different kind of investment — the 15 years of time and effort he'd put in. Rather than taking over as leader and sole owner, he's left with nothing to manage and the need to find a new job.

Analysis

The four partners shared a group objective, but they failed to map a path to that objective in a way that reflected the goals of each individual stakeholder. Had they examined the challenge more deeply and done more advance planning, the group could have chosen from among several options to bring about the succession outcome they desired: a stock transition plan, creation and revision of buy/sell agreements, or an earlier, phased transfer of partial ownership from the older partners to Carlos, with incremental payouts to match.

The group also failed to plan for the unexpected. Back-of-the-envelope calculations had told them the business could weather two retirement buyouts at the same time, but they didn't foresee the sudden need for three partners to leave simultaneously. Because that need arose without warning, the group could not be particular about the market window, and may have sold for a price that didn't return as much value as it should have.

Finally, the four partners focused on financial elements of succession planning — but even if the capital had been available to leave Carlos at the helm, what kind of team would he have been leading? Training and preparing a second-in-command for each of the four top leaders would have left the company with more operational flexibility when the big change came, and may have increased the partners' options at the critical moment.

Volume 2

Establishing a foundation

Succession planning means different things to different people: it can be as simple as naming a family member to take over, or as complex as overhauling the structure of the business to align it with long-term objectives. Many businesses don't pay enough attention to succession planning in any sense of the term. Still fewer see the true scope of the challenge. Effective succession planning isn't only about deciding who will run the business — it's just as important to determine what kind of business those people will run.

This thinking can upset the assumptions owners may have held for a long time. A business may have operated for years as a sole proprietorship or a closed partnership. But will it continue to operate in that form? A business owner may have his or her own sense of what the business is worth — but what is it worth to other people, with other perspectives, in other circumstances? Some may assume succession doesn't cost anything if all they think it involves is handing over the keys. Yet in practice, moving a business into its next generation of ownership can impose significant costs, some of which require significant liquidity. Without foresight and planning, the cash may not be there when it's needed.

The ultimate goal of succession planning is to understand the value of the business, to preserve its value and future growth potential, and to pass it forward intact. There is no doubt it is important to pass the business on to effective successors. But before anyone gets a new parking space, the current generation of leadership has a lot of work to do.

No matter who is in charge, every business owner wants to see his/her enterprise keep creating and accumulating value.

Form and function: choosing the appropriate entity structure

Entity structure is a fairly straightforward choice for public companies, which are almost always C corporations because that legal structure allows the entity to be separate and apart from its shareholders, directors, and officers.

Closely held businesses have more choices to make — which can complicate the decision process. Succession planning isn't the only factor that determines which structure suits the company's long-term needs. Exposure to liability, access to capital, and the personal financial needs of the owner and other stakeholders all enter the equation.

Entity structure is a necessary part of any plan to move into a new generation of ownership because it has a significant effect on business taxation, personal taxation, and the company's ability to transfer wealth. In addition to sole proprietorships, closely held businesses can choose from many different structures. For a business to match its structure to its future needs, it is worth examining the pros and cons of several potential forms: partnerships and limited liability companies, S corporations, and C corporations.

Remember that a succession process involves more than one kind of stakeholder. There are the significant owner-managers who no longer want active participation in the business, and are likely to want to monetize their investment, and then there are the people who intend to remain with the business and continue to contribute to its success. The tax and other implications of an entity structure choice will generally affect the fortunes of both these groups, and this decision has a lasting impact on future options for business succession. This discussion will guide you through the various choices to consider and how they can affect long-term plans.

The ultimate goal of succession planning is to understand the value of the business, to preserve that value and its future growth potential, and to pass it forward intact.

Partnerships and limited liability companies

As with the other entity choices for closely held business owners, there are both tax and non-tax reasons to conduct business as a partnership. The biggest disadvantage for partnerships is that the general partners have unlimited personal liability that can affect their personal assets. However, in a limited rather than general partnership structure, a limited partner is typically only at risk to the extent of his or her investment. For this reason alone, many owners choose not to operate a business as a general partnership.

However, the recent development of the limited liability company (LLC) — which affords the corporate “veil of protection” but is taxed like a partnership — has changed the liability issue.

What’s the appropriate entity structure? The choice depends on what a company’s stakeholders want to achieve. It also depends on the makeup of the ownership and management teams, as well as the company’s overall strategic plan.

Often, the better structure will become apparent when viewed through the lens of estate planning — such as when owners use a family limited partnership to help reduce the tax liability when they transfer wealth from one generation to another. Stock transfer techniques can also overlap with structuring objectives, as in the case of an employee stock ownership plan (ESOP). Choosing one corporate structure over another may enhance the tax benefit of certain compensation plans. The ability to conduct future tax-free stock swaps, or the expectation of a public offering are also potential considerations.

Looking for more technical details on the various entity choices and their pros and cons? Read “In the details” at the end of this section.

S corporations

An S corporation is a separate legal entity in the same way a C corporation is. But instead of paying federal corporate income taxes, it functions as a “pass-through”— dividing income or losses among its shareholders, who then pay taxes on any gains as part of their personal income.

The decision to convert to S corporation status can make things more complex for a company and its owners, assuming the organization meets the requirements for that standard in the first place (it must be an individual or certified trust with no more than 100 shareholders). But this type of conversion can also help contribute to an effective succession plan. That’s because pass-through entities allow tax advantages in many ownership transfer plans. To preserve these advantages, it may be a good idea for S corporation shareholders to lock in their status with agreements and policies that keep the corporate structure from being terminated without their consent.

When a business is transferred to a new generation of ownership, the way taxes affect that transfer of value — for both the company and the individual stakeholders — can make a significant difference in how much value endures. Choosing an S corporation brings a number of complications that affect companies in the near term, as they work to address tax planning. The effect of a pass-through structure on eventual succession should be a consideration in the way any closely held company approaches its long-term plans.

C corporations

A C corporation is a legal entity that is separate from its owners. This gives both the company and the owners certain advantages in taxation, liability, and other areas. A C corporation is a common business entity choice for large, publicly owned companies, and can sometimes be a useful choice for private businesses.

When business succession plans are on the table, taxation is important. It’s likely the reason a business owner chose the company’s existing entity structure. But the decision to “go corporate” often revolves around liability as well. Because a C corporation is a separate legal and taxable entity, it can help give business owners a firewall against both legal and financial exposure that partnerships and sole proprietorships may not. No matter how deeply a person identifies with his or her business, it can be beneficial to keep one’s personal affairs separate from the corporate entity.

However, it is important to remember that choosing a corporate structure can add compliance costs, such as SEC and Sarbanes-Oxley reporting requirements for public C corporations. In some cases, a closely held C corporation may actually experience some tax disadvantages.

Alternatively, limited liability companies allow some of the same protections for business owners as a C corporation — similar isolation between personal and corporate affairs, including legal and financial exposure — but that form of entity is relatively new and still comparatively untested in the courts. C corporations have been around for a long time, and many individuals feel more comfortable with a familiar model.

Other reasons to operate as a C corporation may involve future plans to expand or to acquire stock. Rules limit how many shareholders an S corporation can have — and if a company with multiple generations of owners exceeds this limit, it may find a C corporation a workable alternative. A C corporation can also help a company achieve tax-preferred treatment in cases such as the sale of stock to an employee stock ownership plan, in which case that structure can help the owner defer capital gain.

Implications for succession planning

The choice of an entity structure can change the complexion of a succession process in a number of ways. If the current ownership wants its heirs to own and run the business later on, a pass-through entity such as a partnership or S corporation may make it easier to move money from entity to shareholder and transfer full or partial ownership interests with less tax and regulatory difficulty. On the other hand, a business that sees its future in an initial public offering (IPO) might prefer the traditional benefits of a C corporation.

No matter what future a business envisions, a structure that helps a company and its stakeholders grow, keep, and transfer value in alignment with its long-term strategy is a foundational piece of the succession planning puzzle.

What it's all worth: business valuation

The value of a business has a profound impact on many succession planning issues, including retirement plans, gift and estate taxes, compensation levels, insurance, agreements among shareholders, and corporate finance strategies.

To move forward effectively, any decision about succession planning needs to incorporate an accurate plan for valuing the business. While the process of determining valuation for closely held businesses has a basis rooted in professional standards and methodologies, in reality, it can be as much an art as a science.

Measuring value in a closely held business

Assets like cars or real estate are easier to value because there is an active secondary market for them and there are comparable sales to help determine what they're worth. But there is no widespread secondary market for closely held business interests, and businesses are seldom similar enough for comparable sales to help an appraiser. That's why appraisers must turn to other methodologies to approximate the value of a business.

It's generally accepted that there are three basic ways to describe the value of a business: fair market value, investment value, and liquidation value.

Fair market value. This is the hypothetical cash exchange price that a willing buyer and seller would agree upon as payment for the company with mutual knowledge of all the relevant facts.

Investment value. This is the value the business represents to a specific investor — a successor in a family business or a competitor looking for a company to buy — and incorporates specific considerations above and beyond the fair market value cited above.

Liquidation value. This value is based on the assumption that the business is no longer viable — worth more dead than alive — and the owner is compelled to sell its assets piecemeal.

Digging deeper: A detailed look at standards for evaluating business value

Fair market value

If there were a broad market for the business, this is the price that the market forces of supply and demand would arrive at. It assumes all of the parties are acting freely, without any duress or compulsion. If there are no recent bona fide offers from unrelated parties, the valuation professional is left to speculate on what a hypothetical buyer would pay. The IRS regulations follow this basic premise for valuation.

Several factors can diminish the fair market value of a stakeholder's interest in a closely held business. For example, the interest may or may not include voting rights, and voting stock would be more valuable than nonvoting stock. Or if the amount of voting stock offered for sale is not enough to gain voting control over an existing majority owner, that minority interest would not be worth as much per share as the majority interest. Stockholder agreements may constrain value by restricting the transfer of ownership to other individuals. As a result, there may be no readily available secondary market for the shares, especially for minority shareholders, because a strategic buyer may not be interested in purchasing anything less than a controlling position in the company.

Investment value

Because this method of valuation depends on the interests of an individual investor, it can vary widely from case to case. It's based on a potential buyer's investment requirements and expectations. The investment value may change based upon intangible factors, such as the brand value attached to a long tradition of family ownership, or possible synergies a strategic buyer of the business might achieve.

For example, a strategic buyer may be a competing corporation with enough administrative infrastructure capacity to run both companies. When they combine, administrative costs in the acquired company potentially could be eliminated, resulting in greater profit than what the two separate competing entities generated before.

Liquidation value

When a defunct company is being broken down into saleable assets, the expected timing of the liquidation can affect this valuation method. In a forced, immediate liquidation, for example, assets might diminish in value because there isn't time to shop them around to several potential buyers. Alternatively, a more orderly, less hurried liquidation could bring a higher sales price.



Sometimes, a valuation report on a company will include analyses that use two or more of the values defined above. For example, a business owner contemplating the sale of his business may want to compare the fair market value of the business to the investment value a synergistic strategic purchaser or family member might offer.

Creating value in a closely held business

Value is not determined solely by present-day cash flow. In fact, the prospect of future cash flows matters more; so do prospects for future growth. Investors value investments based on the returns they can expect over the lifespan of the investment.

For a closely held business, cash flow can include dividends, salaries and benefits for owners, and projected sale or liquidation proceeds. That's why those who evaluate deals — including investment bankers, valuation professionals and equity analysts, as well as business owners and operators who actually acquire businesses — use expected future cash flows to estimate the current value of a company. Many factors affect the value of the cash flow stream: the current cost of capital, the timing of the cash receipts, the expected growth or decline of the cash stream over time, and the risk that the expected cash flow stream will not be achieved.

Valuation specialists consider many other factors while deciding on possible future cash flows, including:

- Earnings history and nature of the business
- Industry and general economic conditions
- Company financial condition, net worth, value of non-operating assets and intangible value
- Current and estimated future market share
- Earnings capacity of the subject company and similar companies
- Dividend capacity of the subject company and similar companies
- Size of the interest offered by the subject company

Methods to calculate value

Generally, those valuing businesses choose from among three approaches when preparing their analyses: the income approach, the market approach, and the cost approach.

The valuing of a business may involve one or more of these valuation approaches. For example, the valuation professionals may use the income approach to appraise the value of business operations, then use the market approach as a “reality check” to verify the results from the income approach.

Income-based approach. This approach estimates the value of business operations based upon the present value of expected future cash flows or operating income. Many argue that it provides the most accurate value, because investors buy based on expected returns.

Market-based approach. The market-based approach is grounded in “real-world” transactions — it estimates value of the subject company by comparing the market price of comparable companies. However, as previously noted, among closely held businesses, comparable companies can be hard to find. For this reason, professionals often turn to market-based multiples, such as price/earnings ratios, then adjust these multiples for differences in risk and growth potential between the subject company and the guideline companies. Generally, the more similar the companies being compared are, the better the valuation guidelines will be using the market-based approach.

Cost-based approach. The cost-based approach estimates a value based on the fair market value of a company's assets, minus the fair market value of its liabilities. The cost approach may be hard to apply to many businesses, because many of their most important assets are often intangible.

These are broad categories. In practice, the details of a particular transaction can adjust a business' value up or down, no matter which valuation approach and methodology are utilized.

Valuation discounts

Another way experts can fine-tune their judgment of a company's value is to compare closely held business interests with other investment types. They apply value reductions, or discounts, to account for certain disadvantages that are inherent in owning closely held stock. For example, the benefit derived from some estate and gift tax strategies relies heavily on these discount factors.

If a company is too aggressive in using these discounts to try to depress the value of a business interest and save on taxes when it's transferred to new ownership, the IRS may challenge the result. In particular, the IRS has taken a close look at discounts used in family limited partnerships — a way to transfer ownership in a family business that has become increasingly popular. When a business of any type uses valuation discounts in a succession plan, a formal discount study should be prepared by a credible valuation specialist. This study will help set the appropriate discount and provide analytical support which may be used to defend against an IRS challenge.

There are several types of valuation discounts:

Control discounts. If a shareholder of a closely held company has a majority control of the voting stock of the company, that individual can dictate major business decisions. Since a minority shareholder holds this type of authority, his or her interest would not be as valuable as that of someone with majority control, and this is taken into account.

Lack of marketability discounts. A ready market of willing buyers for a person's interest in the company would generally enhance the market value of the investment. Conversely, if there isn't a ready market, the investment is typically less desirable, and a marketability discount may apply.

Blockage discounts. Sometimes, a company's stock has a ready market, but the block being valued is too large to sell readily. In these cases, a blockage discount would be factored into the valuation to account for this disadvantage.

Stock restrictions. Some closely held companies have rules or agreements that restrict the stock so it can only be sold back to the company, or to the other owners. Limiting a shareholder's options this way often makes the ownership of the stock less desirable, and could trigger an adjustment during valuation.

Implications for succession planning

Only by understanding the true value of an enterprise can a business owner make appropriate long-term plans for it. And even for a business that appears simple, valuation can be fairly complex. In separate conversations during one recent transaction, a company's CEO named a ballpark figure three times the amount the same company's CFO put on the table. At some point, a company's leaders need a common, data-driven approach to determine whether it's the appropriate time to sell or whether they should remain engaged and continue to build value.

Valuation also affects the smoothness and efficiency of transfers as part of succession and also can help parties save money by transferring shares at defensible discounted values for tax purposes.

If a business doesn't start taking valuation seriously until a sale or transfer is at hand, it can diminish the effectiveness of succession planning. Another important benefit of understanding the value of a business is that a constant, objective sense of valuation helps leaders make better decisions as they run the business day-to-day — knowing not just what the company is worth, but what's driving the growth of that worth.

Liquid gold: corporate finance

Many ownership succession plans lead to the company's ownership being divided, transferred, or consolidated. Making changes like that usually requires cash. The simple vision of handing over the keys is seldom realistic. Some closely held companies may be able to fund their succession plans on their own. But when the process requires a cash payout to existing shareholders that is more than a company has available, it has to turn to external funding sources.

Fortunately for these businesses, the variety of financing sources is greater today than in prior eras. Financial institutions have expanded their services broadly, and more types of organizations compete for this financing business — including commercial banks, leasing companies, mezzanine and private equity funds, and even venture capitalists. Access to alternative outside resources, such as foreign investors and strategic alliances, also may be an option.

There are two basic financing alternatives available to businesses: debt and equity. Debt is simply a loan, with a promise to repay the funds borrowed, plus interest, over a designated period of time. Equity financing involves the sale of an ownership share in the company to another party. There are advantages to using either form of financing. The appropriate answer for a company depends on the specific circumstances at hand and the way the choice interacts with other elements of the succession plan.

While examining these various funding alternatives, it is important to remember that the people and institutions that provide the capital all share one basic strategy. When someone gives a company money, he or she expects to be repaid in the future with a reasonable rate of return. This rate of return translates into the cost the company pays for borrowing the money it requires. The amount of risk perceived in a business — that is, the calculated probability that a company will succeed — is one of the main factors that will determine the cost of capital invested by third parties.

Two ways to raise cash for succession planning

Advantages of debt financing

- Debt financing is finite — the company's obligation to the lender ends when the debt is repaid, and the owner retains control of the business.
- Depending on the strength of the business and the preferences of the owners, some forms of debt can be secured or unsecured and have various levels of covenants to assist owners in navigating potential unexpected events.
- The interest payments on corporate debt are generally tax deductible, which can lower the net effective cost of borrowing the funds.
- Recent relatively low interest rates make debt financing even more attractive. Inflation may make the effective cost of borrowing even lower, because the company pays off its debt in future dollars.

Advantages of equity financing

- Money received by the company stays in the company. There is no commitment to make future repayments of cash.
- Maximizes financial flexibility in the event of a slowdown in operating performance.
- Multiple classes of stock (voting and nonvoting) may allow companies to receive an injection of cash from outside investors without giving up management control of the company.
- Some companies simply do not have the capacity to incur additional debt, which generally leaves equity financing as the most viable alternative.

Cost of capital

Another important factor in determining the cost of capital is the prime interest rate commercial banks charge. Many banks publish these prime rates, and they can change at any time. Originally, this was the interest rate banks charged to their lowest-risk or “prime” customers. In recent times, larger customers have been able to negotiate financing agreements with banks at rates below prime. Thus the prime rate, while still used as a lending benchmark, is somewhat mislabeled. In fact, some banks use the term “reference rate” instead.

How much risk will different capital sources accept? The answer varies dramatically with the nature of the financing they offer. As risks become greater, the lender expects a greater rate of return. Debt financing is generally viewed as lower risk capital to the investor because it is usually secured by a lien on the assets of the company. Unsecured senior debt typically will have priority over subordinated debt and equity positions, making it less risky than the latter two forms of capital. If the borrower defaults and is unable to repay the loan, the lender has first claim on the assets of the company.

At some point, the perceived risk reaches a level that forces the interest rate — the cost of money — so high the company is unable or unwilling to pay it. In this case, it may be necessary to sell part ownership in the company instead. Equity investors who buy part ownership can vary considerably in the amount of risk they are willing to assume. Investors in publicly held companies work to manage the risk on their investments by seeking entities with demonstrated track records. Venture capitalists, on the other hand, are willing to take greater risks, and often purchase equity in small or early-stage companies.

Implications for succession planning

Owners of closely held businesses often rely on those with whom they have built client service relationships over many years, such as a banker, lawyer or insurance broker. As a result, they may not always shop aggressively for a capital structure that gives them increased power and flexibility. More specifically, when a succession plan calls for financing, or for shifts in financial structure (for example, through a leveraged dividend or a minority equity investment), companies may limit their options by relying solely on historical relationships that might have served them during an earlier phase of their company’s evolution.

If owners determine that their ultimate goal is to sell the business, implementing the appropriate capital structure can help the business weather storms before, during, and after the eventual handoff. It’s important to approach finance with a long-term view.

In summary

The way a business structures itself, assesses its value, and goes about obtaining capital all sound like here-and-now concerns. And they are: each of these disciplines is vital to the work of managing a business in the present day.

It’s not always easy to see how these decisions influence business succession plans that may not take effect for many years. But they form the foundation on which those future plans will rest.

These types of decisions may lock in circumstances and compliance obligations that can have significant impact years later when it’s time to transfer ownership. Each of these decisions has a profound material effect on the nature, value, and viability of the business and its ability to persevere under anyone’s leadership.

Succession planning is a process, not an event. And that process starts for each business the moment it first opens its doors. Some businesses realize this. Other businesses file succession planning under “someday.” But someday typically arrives sooner than most business owners expect.

While the following scenarios are hypothetical, they are drawn from similar experiences that family businesses we work with have faced. They are intended to illustrate the pivotal role that decisions about entity structure, business valuation, and financing options can play in the succession planning process.

Different decisions, different outcomes

Forty-five years ago, two young professionals got their degrees and certifications at about the same time. They've spent the decades since in friendly competition — the city is big enough for both of them, they've kept each other on their toes, and each has seen their business grow steadily from a one-person shop to a thriving concern that employs dozens.

Now, retirement looms for both Seth and Kate. As part of growing consolidation in the industry, they're both receiving solicitations to sell their businesses to larger strategic buyers. In addition to securing the personal fruits of life after work, both of them want to keep the doors open for the younger people on their staffs.

Seth set his practice up as a C corporation many years ago because of the fundraising and liability advantages he saw in that model. He has always expressed the value of his business from an income-based point of view — he billed \$18 million last year, so he considers himself to be the owner of “an \$18 million business.” Because he prefers to keep the business closely held despite the C designation, he used debt rather than sale of equity to fund a major expansion three years ago.

Kate had a partner for a time, and even though she bought her out more than 20 years ago, she has kept the business a Limited Liability Corporation. She has a financial advisor who occasionally updates her estimate of the business' value according to the income, market, and cost bases, so she's able to keep tabs of ups and downs. Kate has a line of credit that she's used as sparingly as possible by ramping her expansion and retooling needs through several incremental phases.

Seth just walked out of a meeting with his business advisors feeling shocked and disappointed. As it turns out, he may have to scale back his personal retirement plans,

and his professional practice may be liquidated as part of its sale. Things might have been different if he were able to revert to an S corporation or sole proprietorship — that would have sped the transfer of ownership shares and spared both him and the company large tax bills — but it's too late to make that change. The debt he incurred expanding the business left it with no liquid room to maneuver in arranging a sale. Seth's biggest disappointment was learning that based on offers from potential buyers, his “\$18 million business” was going to sell for no more than \$7 million.

On the other side of town, Kate has found that the pass-through LLC structure left her many more options in transferring ownership of the company, and preserved more of her returns from taxation. She would have preferred a higher sale price — wouldn't anyone? — but the offer she accepted was in line with her expectations because she'd paid regular attention to valuation over the years. Finishing the deal will require some liquidity, but she's got plenty of credit available on favorable terms to see it through. With those concerns safely addressed and a well-funded retirement ahead, Kate plans to meet her husband at a travel agency on the way home from the meeting.

Analysis

The factors that made Seth's outcome so different from Kate's were rooted in decisions that appeared to have nothing to do with succession planning when they each made them years before the fact. Some business owners end up in a favorable position because they set up what turned out to be beneficial structures years ago without paying careful attention to the reasons. Others may rely on knowledge and experience — either their own or a consultant's. What's clear is that getting advice and putting in the time, money, and effort to plan ahead is an investment that can pay for itself many times over in the end.

In the details: Entity selection and business succession

Pros and cons of an LLC

Pros

Administrative simplicity. Partnerships are easier to set up than corporations and are generally less costly to administer.

Control over distributions. Partnerships can allocate items of income and expense among the individual partners in any manner the partners agree upon, subject to certain IRS guidelines. Partnerships can also make distributions of cash to partners that are not in direct proportion to ownership, while S corporation shareholders may only receive distributions in direct proportion to their stock ownership.

Deductibility of losses. If a partnership or LLC creates debt for the owners, they can deduct losses that debt generates even if the deduction exceeds their investment basis in the company. Generally, the IRS will only allow owners to deduct losses to the extent that they have “basis” — you can’t write off two dollars of losses if you have only one dollar invested. But partnerships allow owners to count partnership debt as “skin in the game” if the partners are personally liable for the debt. This advantage may be less powerful under an LLC than under a general partnership, because the LLC’s liability protection mitigates the personal risk that allows owners to deduct the losses.

Cons

FICA/self-employment taxes. S corporation shareholders pay FICA/self-employment taxes only on “reasonable compensation” paid to employee owners. Any profit distribution above that amount isn’t subject to the tax. For partnerships and some LLCs, all income from the company is subject to the tax if the partner materially participates.

Treatment of losses. Section 1244 of the Internal Revenue Code allows a qualified small business owner to get ordinary loss treatment (rather than capital loss treatment) on a portion of the loss on the sale of stock when a shareholder sells his entire interest in the corporation. But the provisions of Section 1244 do not apply to partnerships or LLCs taxed as partnerships.

“Check-the-box” regulations. These IRS regulations allow an unincorporated business to select either pass-through treatment or regular corporate treatment by simply checking a box on an IRS form. If no box is checked, the regulations provide default treatment: to be treated as a pass-through LLC. These regulations reduce the threat the IRS would try to re-characterize a pass-through limited liability company as a regular C corporation and impose C corporation taxes. As a result, the popularity of LLCs has dramatically increased.



Pros and cons of an S corporation

Pros

No double taxation...

- On profits: S corporations avoid the double tax associated with C corporation dividends, because the individual shareholders of an S corporation report the annual corporate financial results as part of their personal income rather than as dividends.
- On proceeds: When a C corporation holds appreciated assets such as real estate, its shareholders face double taxation on the gain from the sale of those assets, as described above. S corporation status can eliminate the double tax in this case; however, a special built-in gain tax may apply if the S corporation was a C corporation at any time during the 10 years prior to the sale.
- On liquidation: If an S corporation decides to liquidate, shareholders avoid double taxation because the gains the corporation makes on the distribution of assets will increase the shareholder's stock basis in the S corporation. This "step up" in basis offsets the taxable gain the shareholder would otherwise realize on the receipt of the assets in exchange for the stock in liquidation.

No self-employment tax on earnings. Unlike partners and sole proprietors, S corporation shareholders are not required to include pass-through earnings from the business in income subject to self-employment taxes.

Pass-through savings. If a C corporation sells an item and transfers the proceeds to its shareholders as salary, it incurs a taxable capital gain and an ordinary deduction for the salary. The proceeds received as salary become ordinary income on which the shareholders must pay tax. The S corporation's pass-through ability lets those proceeds go to the shareholder without additional tax.

Accounting flexibility. Generally, regular C corporations must use the accrual method of accounting if gross receipts exceed \$5 million. However, for tax purposes, an S corporation does not. It can elect to report taxable income under the cash receipts and disbursements method of accounting, which some businesses find gives them more flexibility in matching actual cash flow with the timing of taxable income and deductions.

Cons

Shareholder limits. An S corporation faces restrictions on the type and number of shareholders it can include, and on its ability to issue multiple classes of stock. If a violation of these rules inadvertently triggers a loss of S corporation status, the owners may see a large unanticipated tax cost. So companies that choose S corporation status must be careful to maintain their qualifications. For example, if the owners of an S corporation pay dividends to shareholders that are not proportionate to their ownership interests, the IRS may argue that there are effectively multiple classes of stock and terminate S corporation status, leading to double taxation on all the dividends paid.

Personal responsibility. In an S corporation the shareholders, rather than the corporation, are individually responsible for paying quarterly estimated income taxes on the corporation's taxable income. Many business owners do not like this additional burden, particularly if the corporation does business in multiple states. However, the availability of state composite income tax returns can ease the shareholders' individual state tax filing requirements.

Costs to owner-employees. Under an S corporation, employees of an S corporation who own greater than two percent of the stock may have to pay personal tax on the value of certain fringe benefits.

Financial transparency. This is either a pro or a con depending upon the owner's perspective. Since shareholders must report the S corporation's income on their personal income tax returns, they will have a sense of the corporation's level of earnings. The senior controlling shareholder may or may not want that information to be widely known.

Pros and cons of a C corporation

Pros

Flexibility in selecting a fiscal year end other than December 31

Maximum corporate tax rate is lower than maximum individual income tax rate

Cons

Double taxation...

- Of earnings: A C corporation pays corporate income tax on each dollar of profit and when the dollar of profit is paid to the owners as a dividend, and the owner pays income tax on the dividend a second time. If closely held business owners try to avoid double tax by paying inflated salaries to employee owners instead, the IRS may recharacterize a portion of the salary as a dividend and deny the salary deduction for the corporation under the rules for unreasonable compensation.
- Of gains from sale: The C corporation double tax also applies to corporate assets sold for a gain. The corporation pays tax on the gain on the sale of the corporate asset, and when the after-corporate tax cash is distributed to the owners, they pay tax on it again.

Inability to retain earnings. Closely held owners cannot simply retain the earnings in the company to indefinitely defer paying the dividend tax, because of the IRS's accumulated earnings tax. Under these rules, C corporations cannot accumulate cash in the business unless there is a valid business reason. The IRS can recharacterize the retained earnings as dividends and charge the corporation a penalty tax equal to the highest marginal individual income tax rate.

Volume 3

Developing future leaders

The faces behind the boxes

Succession is part of every company's future. The question is when it will happen — and when to start preparing. Whenever that day comes for your company, a lot will depend on choices you made years before — and not just about who will take over the top job.

Consider the fictional example of two closely-held companies — Alpha Systems and Omega Associates — friendly competitors in the same industry and region. Both are busy with strategic planning and operations, and both teams know succession planning is part of their talent management imperative. But the similarities end there.

Omega's senior leadership and board are okay leaving succession to chance. In their view, they grow, hire, and promote all the time. At any given moment, they have a leadership cohort in place that knows how to run the business. If the pipeline ever breaks down, they can hire leaders externally, which is better than trying to create them. As the CEO has said many times, leaders are born, not made.

Over at Alpha, the executive team views succession as an integrated part of its planning process. Alpha leaders there have devoted a management retreat to defining their approach to management development. They know succession will put a new generation of people in charge of a company that may not resemble the current one very closely — and that planning, not faith, is the key to establishing a robust pipeline of capable new leaders. Most importantly, Alpha's leaders know succession isn't a linear progression of aligning people to job titles. They value "optionality" in their people — the potential to grow in multiple possible directions tomorrow, which in the long term outweighs the more tangible performance they demonstrate in their current jobs today.

Both companies in this example have made choices about the interlocking challenges of developing the next generation of leaders and structuring their compensation in a way that both encourages and rewards that development. About the only lesson in common between the two examples is how profoundly present-day decisions can affect the fate of each organization years or even decades down the road.

Succession planning is about more than naming names. But you will need those names. Eventually. And you should be confident those people are ready and willing to occupy the critical roles that will carry the organization forward, not only at the top, but throughout the executive structure.

There's a reason this is called "succession planning" and not merely "succession." It's a process, not a moment, and it takes years of careful decision-making to set the stage. A company's current leadership is responsible for working to identify and prepare the next generation long before any nameplates change.

The forces of supply and demand are at play in succession planning. The supply element is focused on assessing and developing talent along defined principles so the people you see as your successors will be ready for their future roles, while the demand element considers compensation planning to make sure those rising leaders know you appreciate them, so they either join or remain with the company long enough to play those roles. Ideally, through a careful process of calibrating supply and demand, leading companies mobilize themselves to accelerate the development of their future leaders.

The decisions you make today won't determine every detail of your organization's future, but they will help define the breadth of your choices. As in the examples of our two fictional companies, the groundwork you lay now can make a difference between the succession you want and a succession you have to settle for.

Management talent assessment and development

A family-owned sole proprietorship or another organization in the early stages of growth may approach management development in a very informal way. The founder-owner may rely on personal, one-on-one interactions to identify and train his or her eventual successors. There may also be special issues such as family dynamics and birthright that need to be considered. What differences separate that experience from the deliberate steps a more mature private business takes to identify and prepare its next generation of leaders?

A thoughtful management assessment and development approach proceeds from a set of guiding principles, progresses through a defined order of key processes, and measures outputs and value added along the way.

Chief among the guiding principles is active executive leadership involvement in the succession planning process. This is something the C-suite should not delegate, and in carrying out this mission, the company's top leaders should adopt an enterprise-wide approach. Furthermore, management assessment and development is not episodic. Leaders should execute continuously on their plan to bring the next generation along, and they should integrate succession with other elements of the company's talent strategy rather than treating it as a standalone process. Finally, while instinct and interpersonal relationships are important, this is often a job for data and analytics — even in smaller companies where everyone works closely together.

With that mindset in place, the job of finding and training leaders breaks down into three key processes, as detailed below.

Key processes in management talent assessment and development

Determine leadership demand

- Assess growth objectives and competitive demands
- Identify critical functions and roles
- Define criteria for capability and potential
- Formulate leadership strategy

Evaluate talent supply

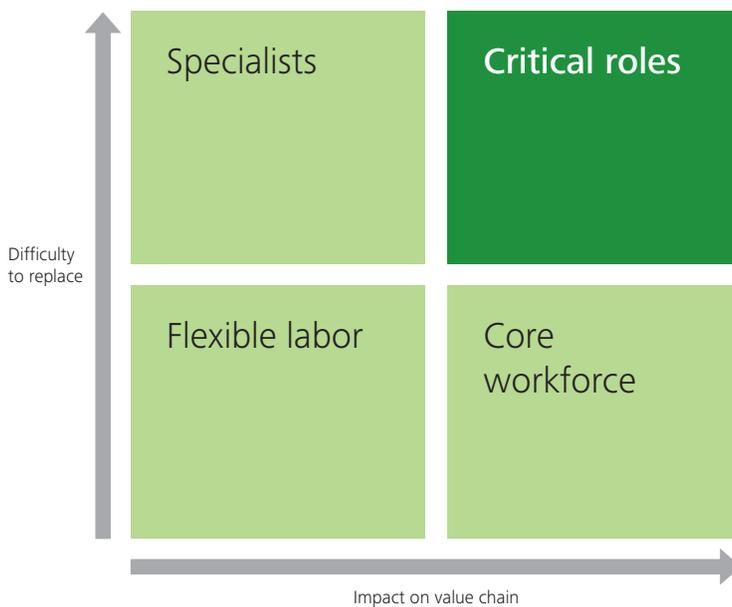
- Validate and review talent pool
- Calibrate talent against business objectives
- Determine priorities and risks

Mobilize and develop leaders

- Determine build vs. buy strategy
- Provide targeted development
- Monitor, measure, and adjust

Critical roles

Roles that have the greatest impact on performance and present the most difficulty in recruiting are the critical ones — and the first focus of leadership development for succession planning.



Determine leadership demand

There isn't a one-to-one correlation between the leadership roles you have today and the ones you'll need tomorrow. That's because the company will change over time — ideally for the better, through growth and innovation. No one can predict the exact nature of the business two years ahead of time, let alone a decade or more, but it's important to make your management plan adaptable and dynamic rather than anchoring it in a present-day reality that might not last. What are the core values that will persist in your organization through the changes ahead? And what is the business strategy that will guide it through those changes?

With this adaptability in mind, it's important to focus energies where they will do the most good. Traditionally, the process of determining demand in succession planning looks at only the top layers of the organization. However, it is useful to take a deeper look. To decide which roles should be "in scope" for succession, evaluate each role along two axes: How difficult is this position to replace? And how much impact does it have on the value chain? The low ends of those two scales represent flexible labor that, while valuable, can come and go without shaking the foundations much. The upper ends of those two scales identify the critical roles on which you should focus your investment of time and resources toward succession.

What will each of those roles demand? This is another opportunity to embrace flexibility. Think not only of the capabilities each person must have in the moment, but also the potential the person in each role must have to keep the organization agile. If a future leader has the appropriate amount of intellectual potential, people potential, motivational potential, and change potential, that leader will likely have the "headroom" to grow during his or her tenure in the role.

It is also important to think about diversity of the pipeline. As the global pool of professional talent becomes more diverse, a company's succession criteria should reflect that diversity. This helps not only to broaden the pool of likely candidates, but also to bring two important components of innovation — diversity of thought and perspective — to the future leadership of the company.

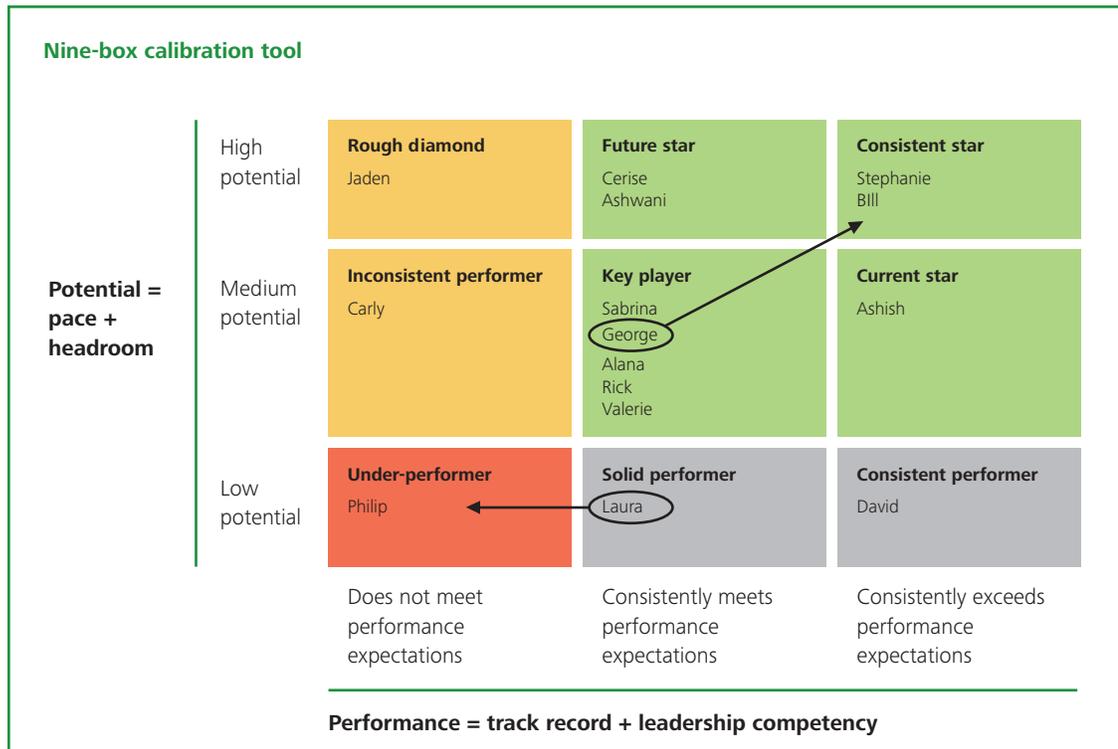
Evaluate the talent supply

Now it's time to begin applying these criteria to actual people. Note that in the Open Talent Economy² — in which access to talent relationships is more important than owning them — your pool of potential future leaders is not limited to people who are present-day, full-time executives. You may wish to include affiliated colleagues, alumni, or even competitors in this calculation.

Develop a common template for future leadership qualities and evaluate each person in your pool using that template. What information can go into that profile? A mixture of facts (previous positions, time in job, past performance metrics), informed predictions (likelihood to leave, time to retirement), and subjective assessments (such as the person's potential across the dimensions of change, intellect, motivation, and people skills). When you have compiled parallel profiles of each person in your management assessment pool, you can begin to think about where each of them fits in your plans for the company.

One way to approach that task is with a nine-box calibration tool. One axis represents potential, from low to high. The other represents actual performance, from those who don't meet expectations to those who exceed them. That grid yields nine locations from "under-performers" to "consistent stars." As you assign each management development candidate to a position in that matrix, you are taking the first steps in determining which people to invest in and the level of investment required.

Some organizations use validated approaches to assist in this assessment and categorization process. They can be useful, because data and benchmarks applied to a management workforce of any considerable size can balloon into a large data management challenge. While marshaling data can be valuable, the real value comes in the human decision-making that guides a mature management succession process. In the end, your goal is to create well-informed impressions of a person's potential — not an aggregate numerical score.



² *The Open Talent Economy: People and Work in a Borderless Workplace*, Deloitte Consulting LLP, September 2013.

Mobilize and develop leaders

One way to reconcile the tangible and intangible elements of this task into a holistic plan is to use the “Four Es” model:

- Build **experience** with “stretch” assignments and strategic job moves that give high-potential leaders a chance to learn new strengths
- Give people **exposure** by focused efforts at mentoring and executive sponsorship that tie personal assessment data to clear, specific objectives
- Align performance **expectations** with compensation and job mobility so natural incentives help drive people in their professional development
- Embrace executive **education** approaches that teach leaders how to think differently, instead of relying on traditional models that reinforce conformity

When analytics keeps this process based firmly in empirical fact — and when proper governance lets the company keep abreast of its ever-changing “depth chart” and the return on its investment in people — the principles behind the “Four Es” can help a company develop a rich lattice of growing leadership talent instead of a narrowly defined pipeline. A key for senior leaders is to own the process with support from HR, not to delegate it.

In the process outlined here, you’ll end up with categorized assessments of the people who may align with future leadership roles. Chances are those will be broken up, at least at the outset, by business unit. Recall, though, that one of the key principles of management development is to treat it as an enterprise-wide mandate. All those departmental assessment matrices need to come together into a single, enterprise-level calibration that shows the company’s entire leadership pipeline in a single picture.

This is a rewarding part of the process — and a tricky one, because it’s where turf can get in the way. As they assess each other’s teams, senior leaders need to be able to challenge each other’s assumptions and conclusions without becoming defensive. When everyone rallies around the broad pipeline view, it’s possible to build strategies that pinpoint which future leadership roles will respond effectively to internal development and which ones will require acquisitions from outside the current workforce.

And now the good part: With roles defined, people assessed, and strategies in place, the organization can work to create personal development plans for the actual individuals whose careers have been at stake all along.

This is where the difference between small-scale, ad hoc succession and methodical, process-driven management development can make a meaningful difference, because by planning, you’ve created lead time. For each person the plan embraces, you can apply different growth strategies that may have been impossible otherwise. For example, developmental career pathing can chart the sequence of experiences that will lead a person from where he or she is today to the role you would like him or her to occupy years from now. Or a combination of coaching, networking, and formal learning can “stretch” a person’s abilities in much the same way an athlete develops strength and flexibility through long-term training. You and your talent team can determine the effective way to push each person toward his or her potential — but because you’ve been deliberate in setting the terms, you have the luxury of time to make those decisions meaningful.

This approach often works because it is built around meaningful results. Like any business process, it must yield value you can identify — like an understandable line of sight into your future leadership pipeline, a defined vision of your organization’s leadership requirements and talent readiness, and actual lists of internal successors and sought-after acquisition targets. When you establish concrete expectations, you can communicate them, which can improve morale and loyalty where you need it most.

There isn’t a decision in the daily operation of your business you leave to chance. Determining who will make those decisions when you and your colleagues are gone shouldn’t be any more random. If you account carefully for the supply and demand of management planning — who needs what from whom — it doesn’t have to be.

What do you need from your future leaders?

- Strategic thinking
- Consistent drive for results
- Ability to lead and build talent
- Entrepreneurial edge
- Commitment to the company's mission and values

What do your future leaders need from you?

- To make an impact
- The opportunity to grow
- Competitive compensation
- Rewards and recognition that acknowledge value of contribution

Compensation planning

The principles behind leadership development and the principles behind compensation planning used to be separate. More recently, however, that distinction has blurred. Traditional pension and deferred compensation models have given way to rewards designed to promote a high-performance culture. A new generation of leaders values personal development and opportunity as a form of compensation in its own right. And there is greater recognition that effective leadership and business strategy alignment are what drive the shareholder returns that make everyone's compensation possible.

For all these reasons, management development and compensation planning should work together. When talent and reward strategies align with business objectives as part of a holistic strategy, performance can improve. And because succession planning is one of those objectives, a "total rewards" approach to performance can help secure the future of the organization and its value to stakeholders.

Retaining, motivating, and attracting employees

Compensation alone can't help you retain up-and-coming leaders if those people don't see their relationship with the company as a long-term proposition. You may have calculated what it will cost to keep each key person in your future leadership structure. Have you calculated what it would cost you to lose them? In the development of a business succession plan, the senior business owners should consider what impact the loss of each individual would have on:

- Sales and profits
- Operations
- Plans for expansion
- Customer relations
- Morale and loyalty of other employees
- Mentoring of successor managers
- Potential exposure of trade secrets and loss of employees to competitors
- Cost of recruiting and training a replacement
- Knowledge lost when the person departs

Total rewards and leadership development — leading practices

In addition to compensation and benefits, organizations are focused on enterprise-wide strategic activities and other total rewards as tools for leadership development, performance excellence, and succession planning. Here are some practices that companies have found helpful.

- Review your HR capabilities and consider transforming the department from a compliance orientation to a leadership development orientation
- Add organizational development resources at the board level (if applicable)
- Create internal advisory boards of high-potential employees to solve strategic business issues
- Develop special project and innovation teams composed of future leaders to create additional capacity and growth opportunities
- Develop programs to train leaders to perform in multi-functional roles
- Provide outside executive coaching for key leaders

It can help not merely to identify vital employees, but also to afford them some level of participation in the succession process. The overall plan should account for their goals and expectations. That doesn't automatically mean granting every wish — but some creative compensation strategies, such as long-term incentive plans, can make a difference in retaining succession candidates as well as key employees that are not selected for a larger role in the organization.

Compensation strategies can also play a direct role in the effort to develop successors. If you ask someone to participate in a management development plan, short-term incentives can help motivate people to reach training, educational, and developmental goals, just as long-term incentive packages can help retain successors for years to come. The short-term incentive plan can also be used to motivate leaders to give the succession planning process the proper amount of time and focus.

Types of compensation

Any organization that designs a compensation strategy should keep a number of considerations in mind: In the present day, compensation should not only be competitive and appropriate, but it also should stimulate, recognize, and reward excellence. From a succession planning point of view, compensation strategies can help retain and encourage important company leaders who have an important future role to play, but who will not be owners. There are several different approaches employers can use to help align employee compensation packages with succession planning goals, including:

- **Base salaries** — the fixed component of an employee's annual compensation and an important element in designing an attractive compensation package.
- **Short-term incentives** — annual bonuses that support the business strategy, are often tied to the company's financial performance, and reward employees for meeting business objectives. As noted above, short-term incentives can also be used to support the succession planning process.
- **Long-term incentives** — incentives tied to value creation and potentially long-term performance goals that not only link pay to long-term results, but also foster retention of key employees; this category includes stock options, restricted stock, cash-based performance plans, and "phantom stock."
- **Qualified fringe benefits** — non-monetary forms of compensation that provide a current deduction for the employer, create no income tax for the employee, and form an important part of the total rewards offered to attract and retain key employees.
- **Deferred compensation plans** — either a defined contribution or a defined later benefit that represents a contractual promise to pay at a later date, which can also be used to foster retention of important leaders.

Compensation strategies can help retain and encourage important company leaders who have an important future role to play, but who will not be owners.

Principles in action

Flash forward ten years in the histories of the fictional companies we introduced at the beginning of this volume: Alpha Systems and Omega Associates. The first thing you may notice is that several of Alpha's top executives used to work at Omega, because they were on Alpha's radar all along.

Because Alpha's leaders understood the distinction between performance and potential, they were able to focus their development resources on people with "headroom" — the flexibility, curiosity, and drive it takes to tackle lateral moves away from their comfort zones. That meant leaving many "high performers" right where they were, because those people were most likely to keep performing well in their current roles and not to respond as well to new challenges. The company has gone through several planned moves in its leadership structure, and has also weathered a few surprises due to deaths and defections. In each case, there was a pool of potential successors available, each of whom had been "stretched" through mentorship, cross-functional assignments, and formal training. The people who are poised to lead Alpha into the future include a number of long-term employees who stayed with the company because of meaningful rewards plans that recognized and drove their potential and, through careful and deliberate planning, aligned their interests with the company's business growth strategy. Leadership by design is now part of the company's DNA, because its value has become so obvious.

At Omega, leadership by chance has led to a rougher time. It had high-potential future leaders within its ranks, but because it never identified and nurtured them, they grew to feel either bored or underappreciated. Many of them left, including people in whom the company had sunk costly investments in poorly structured compensation. Some of them are with Alpha now. At the same time, Omega zeroed in on current performance to build its succession plans, and as a result, a number of highly skilled executives were promoted into places where they weren't equipped to contribute. Some of those were labeled failures or burned out as a result. Some of them found places with Alpha as well. A wave of retirees is finding a huge tax bite in the deferred pay they were counting on, and the company has little to show in terms of ROI related to these payments because the plans were not tied to business success. Overall, the leadership ranks at Omega are in disarray. And tomorrow, Alpha and Omega both have make-or-break presentations to the same potential new major client.



Volume 4

Preserving personal and family wealth

How to hang on long after you've let go

Business succession is a long-term process of planning and preparation, but there comes a moment when the leader and the led part ways — when one story becomes two. In this series much of the focus is on the business, how to prepare it for new leadership, and how it should go forward. But the retiring leader's story is just as important.

Like other elements of succession planning, a broad-based approach to lasting personal wealth should begin years before the separation. What many people fail to appreciate is that personal wealth management in a post-succession life stage is not always about complete independence from the business. Some financial ties may endure long after you sever the management ones.

This section explores the particulars and strategies that contribute to the preservation of the individual welfare and personal financial security of company owners and their families. The plan you make for your business can have significant and often surprising effects on the plans you make for yourself in retirement. The financial futures of other key stakeholders are in play as well. In the following pages, we'll examine critical topics like individual retirement goal setting, estate and gift tax strategies, life insurance planning, and investment portfolio strategy.

Retirement planning

Retirement planning is a challenge for any professional who contemplates the end of a working career. For many people, the term evokes a pool of saved or invested wealth. For business owners, however, the outlook is different. In addition to savings, retiring owners may work to create sustainable cash flows that continue to flow from the businesses they've left. In some cases, they may also rely on installment proceeds from the sale that ended their tenures.

Retiring owners who set up these income streams and plan to depend on them need to confirm that the source of cash flow is adequate and protected. Retirement planning for closely held business owners can be especially challenging in the frequent cases when a closely held business owner's retirement plan is linked to other critical issues like developing the next generation of leaders, estate and gift tax planning, stock transfer techniques, valuation, and corporate finance.

A retirement strategy starts with goal setting. What is your vision of retirement? Do you envision spending any time at work, or will you withdraw completely from managing the business? What sort of lifestyle does "retirement" mean in your view — and how much money will it take to make that vision come true?

Be realistic in your goal setting. A future retiree without a clear picture of potential requirements is more likely to fall short of what he or she needs. Some people will map out retirement cash flow levels that are far less than their pre-retirement expenses, while others may actually plan to increase their spending after retirement. The important thing is to understand those desires — and to quantify them in as much detail as you can.

Turn every wish-list item into a concrete action plan, then make sure all those plans for your future are compatible with the plans you're setting in motion for your business.

With a goal in mind, consider what may affect your path to realizing it. Does your plan expose you to the ups and downs of the stock market? Will health needs, family obligations, or taxes make the cash flow you've arranged for feel less adequate a few years from now?

You wouldn't have this wealth to plan for if you weren't skilled at managing variables. Apply that same acumen to your retirement. Use hard data and analyze it to determine what's realistic. Instead of a single-track plan, identify contingencies and alternatives. Turn every wish-list item into a concrete action plan, then confirm those plans for your future are compatible with the plans you're setting in motion for your business.

Once you've established a retirement plan, don't set it in stone. Review it periodically to make sure it's tracking with reality. Don't think of retirement as the absence of a job; think of it as a new job — safeguarding and enjoying the rewards you've worked hard to accumulate.

Estate and gift taxes

Closely held business owners accumulate net worth in their business holdings that subject them to federal and state estate taxes. As one of these owners, you might not have a clear sense of the value of your company, but the tax rules are definitive. There is a value, and it will affect your liabilities as you move into retirement. It will also influence the way you and your family members can inherit wealth when one of you dies.

The federal transfer tax system consists of three separate and distinct taxes — the estate tax, the gift tax, and the generation-skipping transfer (GST) tax.

Legislative history and your future

Step back more than a decade. The Economic Growth and Tax Relief Act of 2001 ("EGTRRA") was part of the package known commonly as the "Bush tax cuts," whose programmed sunset and partial extension remained a focus of policy debate well into the Obama Administration.

EGTRRA included significant changes to the estate, gift and GST tax rules, ultimately providing for "repeal" of the estate tax and no generation-skipping transfer taxes in 2010. EGTRRA gradually reduced the top effective estate, gift and GST tax rate from 55 percent in 2001 to 45 percent in 2009 and increased the estate tax and GST tax exemption amount through 2009 (with an unchanged gift tax exemption of \$1 million). In 2010, EGTRRA repealed the estate tax and further reduced the gift tax rate to 35 percent, leaving the gift tax exemption at \$1 million. EGTRAA also specified that no GST taxable event could occur in 2010.

Importantly, EGTRRA contained a "sunset provision" that would have reinstated the estate, gift and GST taxes to pre-2001 rules starting in 2011 if no congressional action were taken.

As EGTRAA provisions were set to expire, The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act") became law. This included temporary estate and gift tax benefits for 2011 and 2012. Under the 2010 Act, the estate taxes were reinstated to the beginning of 2010 with an exemption amount of \$5 million per decedent and a top rate of 35 percent. The estate and gift tax regimes were reunited in 2011, with an exemption amount of \$5 million and a top rate of 35 percent. Similarly, the GST tax exemption amount was also increased to \$5 million and a rate of 35 percent. The gift, estate and GST tax exemption amounts were then indexed for inflation in 2012 at an amount of \$5.12 million.

The 2010 Act also allowed the estates of decedents dying on or after January 1, 2010 and before January 1, 2011, to opt out of the 2010 Act's estate tax regime and apply 2010 law, which substituted modified carryover basis rules for the repealed estate tax. The election out of estate tax and into modified carryover was complex—and, once made, was irrevocable. For beneficiaries of estates that made this election, assets were generally inherited with the same basis as the decedent had prior to death, with certain modifications.

The 2010 Act also allowed for portability of the unused exemption amount for decedents who died in 2011 and 2012 to the surviving spouse, allowing the surviving spouse to use his or her own exemption plus the unused exemption amount from his or her most recent deceased spouse to offset the tax on subsequent gifts or to offset his or her estate tax. In order for the decedent's unused exemption amount to be available to the surviving spouse, the executor of the deceased spouse's estate had to make an election to convey it and compute the amount to which the surviving spouse was entitled. The GST tax exemption, however, was not portable.

If Congress had not acted, the sunset of the 2010 Act would have taken place. The estate and gift taxes in 2013 were set to be calculated using an exemption amount of \$1 million, a top rate of 55 percent and a 5 percent surtax on transfers in excess of \$10 million until the lower tax brackets and applicable credit amount were recaptured. The GST exemption was set to be \$1 million at a rate of 55 percent.

But the American Taxpayer Relief Act of 2012 permanently extended the estate and gift tax regime, with the exception of the tax rate. The estate and gift tax exemption amount remained at \$5 million, adjusted for inflation each year thereafter. The top rate is set at 40 percent. The inflation-adjusted exemption amounts for 2012 and 2013 were \$5.12 million and \$5.25 million respectively; the 2014 inflated-adjusted exemption amount is \$5.34 million. Similarly, the GST exemption amount

was also permanently extended and will remain at \$5 million indexed for inflation from 2012 with a tax rate equal to the highest gift tax rate in effect at 40 percent. The inflation-adjusted GST exemption amount for 2014 is therefore \$5.34 million. Another significant extension with the 2012 Act includes portability of a deceased spouse's unused estate and gift tax exemption.

What this means for you

The 2012 Act results in significant changes for individuals who attempt to plan their estates in the foreseeable future. Because the 2012 Act provides for a significant increase in exemption, which will be adjusted for inflation, individuals will need to revisit their estate plans going forward.

The wealth of closely held business owners is typically tied up in illiquid assets. So without proper estate planning the estate tax may force heirs to sell the business in order to pay the tax.

The table below shows how the applicable rates and exemption amounts have changed through 2014. It is vital for closely held business owners to understand this as a dynamic environment — governed not only by complex rules, but by rules that have not remained constant. There are elements of a post-retirement plan for which it's difficult to plan, and estate taxation triggered by a death in the family is certainly one of those. But you and your family will still be better off knowing the legal context than if you don't.

Estate gift, and generation-skipping transfer (GST) tax: maximum rates and exemption amounts

Year	Rate	Estate and GST exemption	Exemption
2010	35%	\$ 5,000,000 *	\$ 1,000,000
2011	35%	\$ 5,000,000 **	\$ 5,000,000
2012	35%	\$ 5,120,000 **	\$ 5,120,000
2013	40%	\$ 5,250,000 **	\$ 5,250,000
2014	40%	\$ 5,340,000 **	\$ 5,340,000

* Unless executor elected modified carryover basis rules.

**Increased by amount unused by first spouse that carries over to a surviving spouse, if elected

Building an estate plan entails more than setting up wills, trusts, and health-care directives. The first step is to determine the extent of estate tax exposure in order to prepare the way for further succession planning. To determine the value of your current estate and for assistance in projecting its future value, it's a good idea to talk to a professional financial advisor. Reviewing the situations and strategies that follow is a valuable way to prepare for that conversation.

When developing an effective estate and gift tax plan, you should also consider other elements of succession planning, such as developing and motivating management talent, transferring ownership, retaining key employees, dealing fairly with family members who may or may not be actively employed in the business, disability planning, retirement planning, and investment portfolio strategies. Other volumes in this series treat many of these issues in detail.

Lifetime gifting

Gifting can be a very simple and powerful way to transfer wealth from one individual to another without incurring a transfer tax — especially when the gifting program unfolds over a period of years. After a gift is made, the asset is removed from the donor's taxable estate, so any future appreciation on the gift is removed from the donor's taxable estate as well. The trade-off in making a gift is that the recipient of the gift gets the same tax "basis" in the property received that the donor had prior to the gift. If the same property were bequeathed at death instead, the recipient would receive a free "step-up" in basis in the property.

Any individual may give up to \$14,000 of value to another individual each year without paying any transfer tax — and without eating into the lifetime credit against estate and gift taxes that everyone is allowed under the law. Married couples can give \$28,000 per year per recipient. And the \$14,000 and \$28,000 amounts will be adjusted for inflation.

In order to qualify as a bona fide gift, the donor must give up all rights of ownership and control. Attach any strings, and the gift and its tax benefits will be nullified. There are a few special cases — for example, gifts for tuition and medical expenses can be made free of gift tax consequences, as long as the checks are made payable directly to the school or medical service provider.

Using trusts in estate planning

Trusts are widely used in estate planning, largely because they're very flexible. You can create and fund a trust during a lifetime (inter vivos trusts) or create one by the terms of a will or trust at death (testamentary trusts). The terms of some trusts may allow it to be changed or even revoked by the grantor. Other trusts may be fixed or irrevocable at the date of creation.

In estate and financial planning, there are several common purposes for using trusts.

- **Managing assets.** The responsibility for making investment decisions and maintaining adequate records can be transferred to either a corporate or an individual trustee.
- **Protecting assets.** In certain situations, a properly drafted trust can protect the assets in a trust from creditors of a beneficiary. In addition, the assets may be protected from a spouse in the event of the divorce of the beneficiary.
- **Providing privacy.** The assets, terms, and conditions of a trust are generally not subject to public inspection.
- **Avoiding probate.** The assets that are held in a trust created and funded during the grantor's lifetime are controlled by the terms of the trust, not by the terms of probate. In some states, avoiding probate can save time and reduce administrative expenses.
- **Providing for multiple beneficiaries.** A trust can be created for the benefit of multiple beneficiaries and can allow the trustee to use discretion in making distributions.
- **Providing for special needs.** A beneficiary may have a special need relating to education, health, and so on. A trust can be used to address those special needs.
- **Tax planning.** A trust can be used to help take full advantage of the combined marital deduction and the estate tax credit while assuring that assets can be available to meet the needs of the surviving spouse. For example, your will could leave all your assets to your spouse except the amount equivalent to the estate tax exemption amount. This amount would go into a "by-pass" or "family" trust for the benefit of your spouse and family. Although your spouse would be able to benefit from the entire estate, the trust assets would not be included in the estate of the surviving spouse on his/her subsequent death.

You can implement a trust during your lifetime or under the terms of your will. Or you can establish a trust during your life to begin operation upon your death. In that case, property that passes under the terms of your will could be directed to “pour over” into an existing trust.

You can use a trust established during your lifetime (“inter vivos”) to plan for certain types of assets, like insurance proceeds and employee benefit plans. If these are made payable to the trust, the trustee could collect them immediately following your death without the potential delay and administrative difficulty that may be associated with a “testamentary” trust established under your will. In some states, this approach has the added benefit of avoiding the continuing probate court jurisdiction sometimes imposed on trusts established under wills.

In fact, it may be beneficial to place title to certain assets in an inter vivos trust, and to designate yourself as trustee during your lifetime, to avoid the probate process. Such arrangements are often referred to as a self-declaration trust or living trust. They can be effective in reducing probate time and expenses and avoiding publicity and unnecessary trustee fees during your life.

In creating a trust, be careful in your choice of a trustee — the individual or institution that will be responsible for the management, investment, and distribution of funds. As with any person in any role, the competence of the person you select will vary. Not everyone has the same business judgment or experience.

If you choose an institution instead of a person, remember that an institutional trustee’s existence is “perpetual.” An appointed individual may die or become incapacitated, which negates the continuity of trust administration. If you want to name an individual as trustee, you should consider naming a corporate trustee as a backup if the individual is later unable or unwilling to serve. This highlights one of the advantages of a trust: its flexibility to adapt to changing circumstances. While a trust is generally irrevocable following the death of the individual who created it, you can include a provision that gives the beneficiary the ability to replace the trustee. This authority can be granted to any individual, but typically it’s reserved for an adult beneficiary, such as the surviving spouse.

A corporate trustee can provide management and record-keeping expertise for almost any type of asset and is typically trained in the responsibilities of serving as a fiduciary. In addition, the corporate trustee’s existence is generally enduring. You can count on it to be there long into the future to respond to the needs of your beneficiaries. But there are fees associated with the selection and use of a corporate trustee. It is important to weigh the costs and benefits of engaging such professional expertise according to the situation. You may want to consider naming both a professional and another relevant individual as co-trustees. That way, you can combine professional management expertise with the individual’s knowledge of the family and the needs and circumstances of the individual beneficiaries.

As with any person in any role, the competence of the person you select as trustee will vary. Not everyone has the same business judgment or experience.

Life insurance

Life insurance is a common approach taken to limit estate tax exposure. That's because it can provide instant liquidity on a tax-free basis at the precise point when the cash is needed: upon the death of the insured. Married couples often buy "second-to-die" policies (where the death benefit is not paid until the second member of the couple dies) because the premiums are lower. Often, depending on the will, the bulk of the estate tax isn't due until the second spouse dies, because of the marital deduction afforded transfers between husbands and wives.

But it's not all good news. If the policy is owned by the decedent, the death benefit from the life insurance policy is included in the decedent's taxable estate. If this is the case, the current tax rates may tax up to 45 cents per dollar of insurance death benefit. One solution is to place the insurance in, or to purchase the policy through, an irrevocable trust. The trust must be properly structured and funded so there are no "incidents of ownership" that would cause the death benefit to be drawn back into the decedent's estate.

Often an individual will own permanent life insurance policies and will want to transfer the existing policies to a life insurance trust in order to remove the death benefit from the taxable estate. Take care when implementing such a strategy. The first potential trouble spot is called the "three-year rule" — if a taxpayer transfers an existing policy to a trust, and the taxpayer dies within three years of the transfer date, the face value of the policy will be brought back into the taxpayer's estate. Another complication in the life insurance area is the "transfer for value" rule. If a taxpayer transfers a life insurance policy for value (in a non-gift transaction), the death benefits may be re-characterized as taxable income when they're received. There are exceptions and tactics you can employ to account for the "three-year rule" and the "transfer for value rule." The key to navigating around potential pitfalls is to seek the advice of an estate tax specialist before taking action.

Generation-skipping tax

The estate tax is imposed upon each generation at death. Going one generation at a time, your bequest would go through taxation twice before it gets to your grandchildren. So many individuals seek to "skip" a level of transfer tax by transferring wealth directly to their grandchildren. This was possible before 1986.

In that year, Congress enacted the generation-skipping transfer tax that taxes direct generational "skips" at the highest marginal estate tax rate. During the course of a lifetime, each individual is allowed to transfer an amount up to the generation-skipping exemption amount seen in the table on page 7 to individuals of two or more generations removed without incurring the generation-skipping tax.

If you want to use a generation-skipping tax strategy, you have to account for potential challenges. Some common trouble spots include:

- Leaving property outright to a grandchild or great grandchild while the "lineal ancestor" (his or her parent) is still living
- Leaving property in trust to a child, with the remainder to a grandchild, where the property is not included in the child's estate
- Leaving property in trust from which the trustee pays out amounts to a grandchild while the child is still living

Taken to its deepest level of detail, the generation-skipping tax could be the subject of its own book. But know there are approaches that can address these complications. There are also planning structures you can employ to help preserve family wealth into future generations, such as the "dynasty trust." A dynasty trust is a specially designed and implemented trust that contains family assets into perpetuity. The trust allows family members to use those assets and pay income to family members from those assets over subsequent generations. However, as the assets will be perpetually held in trust and never inherited, no estate or generation-skipping tax will be levied. Over a period of generations, it is not inconceivable that the value of the trust may have the potential to grow at a rate far in excess of the value of the assets had they simply been subjected to transfer taxes from one generation to the next.

Qualified Terminable Interest Property (QTIP)

Property transferred from one spouse to another upon death is generally not subject to estate tax because of the “marital deduction,” which is available for most property left to a surviving spouse who is a U.S. citizen. An unlimited deduction is allowed for a surviving spouse when property is transferred from the first to die, but it will be subject to the estate tax when that individual, the surviving spouse, dies.

You and your spouse must meet qualifications in order to get the marital deduction. One of the more significant qualifications is that taxpayers only get the unlimited marital deduction for property that passes to the surviving spouse without a “terminable interest.” A terminable interest occurs when the property passes to the surviving spouse with an ownership interest that terminates during the surviving spouse’s lifetime.

However, there is an exception to the terminable interest rule. This exception is known as Qualified Terminable Interest Property (QTIP). QTIP property must meet the following requirements:

- The property must pass from the decedent
- The surviving spouse must have a qualifying income interest for his or her entire lifetime, payable at least annually
- No person, including the surviving spouse, may have the power to distribute or appoint any part of the property to anyone other than the surviving spouse during his or her lifetime
- A QTIP election must be executed

So when a QTIP election is made for a trust,

- the surviving spouse will get the income for his or her remaining lifetime,
- the surviving spouse will include the asset in his or her taxable estate upon his or her death, and
- other named beneficiaries will inherit the asset upon the death of the surviving spouse.

If properly structured, there is no estate tax due on QTIP property when the first spouse dies, even though the surviving spouse may have inherited a terminable interest. QTIPs are often used in cases where there is a second marriage, and the family wants to preserve assets for the children from the initial marriage while providing income for the second surviving spouse and avoiding the payment of estate tax when the first of the couple dies. This strategy is typically sound. However, if the second spouse is very young (for example, the same age as the children from the initial marriage), this strategy may not be advisable. Remember QTIP property must provide the income interest in the QTIP asset for the spouse’s full lifetime before the transfer to the ultimate recipients. In this case, the younger second spouse may live as long or longer than the children from the initial marriage. And the children from the initial marriage will not get their inheritance until the younger spouse dies. In this case, the children from the initial marriage may never actually receive any inheritance.

QTIPs are also useful in situations where the surviving spouse may not be able to manage or control spending or lacks financial acumen. In anticipation of those circumstances, the first to die can provide for the comfort and continued income of the surviving spouse while, at the same time, protecting the corpus of the individual’s estate (i.e., dictating the ultimate inheritor or inheritors of the assets). No taxes are incurred upon the first spouse’s death.

QTIPs are also useful in situations where the surviving spouse may not be able to manage or control spending or lacks financial acumen.

Business owners have also used QTIP trusts to transfer ownership to the next generation while saving estate taxes. Here's one way that can work: The patriarch owner of a business makes lifetime gifts to his children of minority interests in the business, say 10 percent (5 percent to each of two children). The taxable value of these minority interests is discounted because of the lack of control and marketability. The owner retains 90 percent ownership, and sets up his will to bequeath half of his ownership (45 percent) to his spouse, and the other half (45 percent) into a QTIP trust. The children are the ultimate beneficiaries of the 45 percent held in the QTIP trust, and will inherit the remaining 45 percent ownership directly upon the death of the surviving spouse.

Because of the unlimited marital deduction, no estate tax is due when the owner dies. When the surviving spouse dies, the stock in the QTIP trust (45 percent) plus the stock bequeathed outright (another 45 percent), or a total of 90 percent, passes to the children. Minority ownership discounts may be separately applied against the spouse's outright 45 percent minority interest and the 45 percent QTIP minority interest, even though the combined ownership interest being passed on to the children does not represent a minority interest (90 percent).

The logic for separating the two 45 percent blocks for purposes of discounting the value is that the shares in the QTIP trust are not under the control of the surviving spouse. For example, the surviving spouse could not freely sell the QTIP shares. Therefore, the holdings are considered to be two entirely separate ownership blocks — and each of them is entitled to a minority discount.

But what if the spouse dies before the owner? Won't the owner then be stuck with a majority interest and no allowable discount? There is a simple solution to this problem: The owner and spouse simply split the ownership between each other while both are still living. In our example, the owner would make a lifetime gift of 45 percent to his spouse. This lifetime gift will not trigger any gift tax, because U.S. citizen spouses enjoy the unlimited deduction for lifetime gifts. Next, both spouses establish "mirror image" wills that set up a QTIP trust to hold the stock of the one who dies first. In this way, neither spouse will be left holding a majority stake outside the QTIP trust.

Charitable deduction for estate tax

As with the marital deduction, individuals may transfer assets to qualified charitable organizations without incurring estate or gift taxes. The tax code specifically spells out this estate and gift tax exemption for charitable giving. Further, qualified charitable gifts are deductible on the donor's individual income tax return, subject to certain limitations.

There are numerous tax-friendly alternatives for charitable gift-giving that use split-interest gifts (like charitable lead trusts, charitable remainder trusts, charitable remainder unitrusts, charitable gift annuities, or pooled-income funds). When properly structured, these gifts deliver full benefits to the charity along with tax savings to the donor and trust beneficiaries. Pick your tax benefits carefully, though. Although assets bequeathed to charity at death are not subject to estate taxes, the same assets if gifted to charity during your lifetime would result in a double benefit — a current income tax deduction as well as removal from your estate.

Twelve-month extension to pay estate tax (IRS Code Section 6161)

Ordinarily, inheritors must pay an estate tax bill within nine months after death. The estate can request a twelve-month extension to pay the tax (under Section 6161) if the executor can show "reasonable cause" for it. The IRS will charge interest during the extension period at the regular floating rate as periodically published and prescribed by the tax code.

In this context, what are some examples of "reasonable cause"?

- The assets of the estate are located in several states and require additional time to administer
- The assets of the estate include receivables that must be collected
- The assets of the estate are subject to litigation or dispute
- The current composition of the estate does not provide the liquidity to pay, and additional time is needed to liquidate assets to pay the tax

If the IRS grants an extension, it may require the posting of a bond, generally for an amount exceeding twice the estimated estate tax due.

Installment payments of estate taxes (IRS Code Section 6166)

If the value of a closely held business makes up more than 35 percent of the “adjusted gross estate” for purposes of calculating the estate tax, the executor can elect to pay the estate taxes resulting from the closely held business over a span of 10 years. The estate tax payments must begin no later than the fifth year following the original due date of the estate tax, which is nine months from the date of death. The IRS will charge interest during the extension and installment period at 45 percent of the regular floating rate as periodically published and prescribed by the tax code.

For this purpose, Section 6166 defines a closely held business as:

- An interest in a sole proprietorship
- An interest in a partnership carrying on a trade or business if (1) 20 percent or more of the partnership capital interest is included in the gross estate or (2) the partnership has 45 or fewer partners
- Stock in a corporation carrying on a trade or business if (1) 20 percent or more of the voting stock is included in the gross estate or (2) such corporation has 45 or fewer shareholders

The measurement date in making the above determinations shall be as of the time immediately before the decedent’s death. Special rules apply to holding companies, lifetime gifts, and businesses held by closely related parties.

Stock redemptions (IRS Code Section 303)

IRS Section 303 allows the estate of a closely held business owner to sell stock back to the corporation with preferential income tax treatment. Such a redemption usually produces little or no income tax because the estate’s income tax basis in the redeemed stock was “stepped up” as of the owner’s death. Under Section 303, if the fair market value of the stock is greater than the estate’s “stepped-up” basis, the gain is afforded preferable capital gain treatment, rather than ordinary income treatment.

Why is this significant? Without the Section 303 provision, a partial redemption of stock could be classified as a dividend, subjecting the full amount of the distribution (without offset from basis) to qualified dividend income tax rates.

This dividend classification would be taxed at a rate of 15 percent for married filers earning less than \$450,000 or single filers earning less than \$400,000. For joint filers earning above \$450,000 or single filers earning above \$400,000, the rate would be 20 percent. In addition, this dividend could be subject to a surtax on net investment income at a rate of 3.8 percent. The 3.8 percent surtax applies to the lesser of the taxpayer’s net investment income (after investment related allowable deductions) or modified adjusted gross income (“AGI”) for those joint filers with adjusted gross income over \$250,000 or single filers with adjusted gross income over \$200,000.

To qualify for Section 303 treatment, the value of the stock in the closely held company must exceed 35 percent of the decedent’s entire adjusted gross estate. The allowable amount of Section 303 redemptions is limited to the sum of the following:

- Federal estate taxes paid, including interest
- State inheritance taxes paid, including interest
- Funeral and administrative expenses allowed as deductions against the estate tax

For Section 303 redemption to succeed, the company needs cash to redeem the stock from the decedent’s estate. One way to provide the needed cash to execute a redemption is through the use of life insurance.

In this scenario, the company buys a policy on the life of the owner and names the company as the beneficiary. If the owner dies, the company receives the death benefit to fund the Section 303 redemption. But remember, if the business owner is older or in poor health, the life insurance may be prohibitively expensive. In such a case, Section 303 redemption may not be the best estate-tax planning solution.

These are some of the most common estate-tax planning approaches, but not the only ones. It is important to remember that succession planning is a stage on which many different disciplines have to interact. When they’re in tune, it’s easier to save estate and income taxes, preserve family wealth, protect shareholders and employees, encourage business success, and promote family harmony.

Life insurance planning

Life insurance is a basic tool to manage the risk of loss and can effectively provide income replacement for a family or business upon the death of a wage earner or key employee. For closely held-business owners, proceeds from life insurance policies may be used to purchase the stock of a deceased shareholder of the company in order to facilitate the transfer of the business from one generation to the next. Life insurance proceeds may also be used to pay estate taxes, and, from an income tax standpoint, a life insurance policy offers several potential benefits:

- Assets can enjoy tax-deferred build-up
- Tax-free withdrawals are allowed up to the amount of investment in the contract in certain circumstances
- Assets may be used as security for a loan from the insurance company without incurring tax on the incurrence of the debt
- Death benefits are generally not subject to income tax

Types of insurance

Despite the complexity associated with life insurance products, there are fundamentally only two types of insurance: term life and whole life. Other insurance offerings such as universal life, variable life, renewable term, term/whole life mix, or second-to-die policies are combinations, enhancements, or variations of the two basic types.

Term insurance

Term insurance provides life insurance coverage for a limited period of time, or term. There are basically two elements to a simple term policy: the cost of the policy usually stated in terms of the periodic premium payments, and the death benefit. The premiums are payable during the term of the life insurance coverage. If the insured dies during the term, the policy pays the stated death benefit to the beneficiaries named in the policy. If the insured outlives the term of the policy, no death benefit is paid and there is no return of premiums.

There are three types of term insurance:

- Annual renewable term
- Level term
- Decreasing term

With annual renewable term insurance, the attendant cost of the coverage goes up as the insured ages. Level term locks in the cost for a period of 5, 10, 15, or 20 years. At the end of each period, the cost increases dramatically. The cost remains fixed at the new level until the end of the next period, when it increases again. Decreasing term is the opposite of annual renewable term. The annual cost of the insurance stays the same going into the future, but the death benefit is reduced.

Despite all the complexity associated with life insurance products, there are fundamentally only two types of insurance: term life and whole life.

The biggest advantage of term insurance is cost. Generally, term insurance is the least expensive way to provide relatively short-term coverage. Term insurance can also be canceled by simply not paying the premium. This is an advantage because sometimes changes in circumstances impact the usefulness of a life insurance policy. Because there is no cash value or return of premium to consider with term insurance, obsolete term policies may be allowed to simply lapse.

However, the biggest disadvantage of term insurance is also cost. Term insurance premiums increase with the age of the insured. While term coverage provides comparatively inexpensive coverage over a stated term, the cost to renew the policy after the original term has expired may be very expensive. It is possible that the insurer may decline to renew the term policy, and the insured will be unable to find coverage at any cost.

A variation on basic term insurance is called "Renewable Term" insurance. These term policies are automatically renewable at the end of the original term. These policies are especially valuable to an insured who has developed health difficulties which would negatively impact the ability to obtain new insurance. However, insurance companies charge more for this feature, and the premiums become much more costly as time passes.

Some term policies have a provision allowing the insured to convert the term insurance into some form of whole life insurance. This feature serves as a hedge against the chance that medical complications will affect the insured's ability to find additional coverage at the end of the term policy.

Group term insurance plans are among the most popular employee fringe benefits offered by employers to their employees. The company purchases term insurance for all employees as a fringe benefit. The employees name their own individual beneficiaries on the insurance. The company is allowed a tax deduction for the premium payments, and the employees may exclude the first \$50,000 of coverage under the plan from taxable income. The value of coverage in excess of \$50,000, if paid for by the employer, is calculated and added to the employee's wages for the year, and reported on the employee's Form W-2, subject to payroll taxes. Qualified group term insurance plans cannot be designed to discriminate in favor of highly compensated employees.

Whole life

Whole life insurance evolved as a solution to the difficulties relating to the renewal of term policies, as described in the previous section. Remember, after a term policy expires, the insured may find that (s)he is unable to find additional coverage at any price, due to advanced age and medical conditions. Whole life, or permanent insurance, was designed to address this problem.

With a whole life policy, the insured is guaranteed coverage and the whole life premium payments are structured in a fixed series of equal payments. As long as the premium payments are made, the insurer cannot cancel the policy. To accomplish this benefit, a portion of each payment is placed in a fund, which will serve to reduce or amortize the financial obligation. Over the years, this fund grows in value and is referred to as the policy "cash value." The insurance company may use the fund to make up any shortfall between the annual cost of the insurance coverage and the annual premium payment required.

With traditional whole life insurance, the fund earns a guaranteed, conservative rate of return. Although this amount grows on a tax-deferred basis, the performance may be disappointing in a high-inflation environment or where better returns are otherwise available through other investment vehicles.

Typically, holders of whole life policies can borrow against the cash value of their policies. These loans are very easy to accomplish, the repayment terms are flexible, and the cash can be accessed quickly. However, the interest is not deductible for income tax purposes by individuals, and is deductible in only a very limited set of circumstances by business owners.

A whole life policy can be cashed in with the insurance company at any time. After the owner receives the cash, the policy is simply cancelled. The cancellation of a whole life insurance policy is typically a taxable event. Losses on the cancellation of a whole life policy are not typically deductible for individuals, although they may be in the case of a business-owned policy.

Universal life

Universal life is a variation of traditional whole life insurance. The universal life concept came about to address consumer dissatisfaction with the conservative, guaranteed rates of return provided by the traditional whole life fund. In the early and mid-1970's, people figured out they could cancel their whole life policies, buy cheaper term insurance, and invest the premium savings in other investment vehicles that significantly outperformed the guaranteed rates provided in the whole life funds and, in so doing, create an individualized fund that could pay a much higher return.

To counter this exodus from the traditional whole life insurance product, insurance companies developed universal life. Universal life policies work just like whole life policies in that the insured's policy cannot be cancelled by the insurance company and a portion of each premium payment is placed in a fund with a guaranteed minimum return. The difference is that with universal life, as market rates of interest increase, the policyholder will similarly achieve a higher return on its fund, and depending on its contract, a higher death benefit. The "downside," of course, is if market rates go down, the return to the policyholder, and potentially the death benefits under the contract, will similarly decrease.

Variable life

The third type of permanent insurance is called variable life. It was developed to try to improve on the shortcomings of both whole life and universal life policies. This type of policy allows the insured to direct the insurance company to invest the fund cash into mutual funds or money market accounts. As long as the investments perform well, the insured does very well with this arrangement, outpacing the more conservative other whole life policies. At the same time, however, the policyholder is also taking on the potential downside risk of the selected investments.

Term/whole life mix

A popular strategy is to purchase a mix of term insurance and whole life insurance. In this situation, the term policies provide the greatest death benefit for the least premium in the short run, while the whole life policies provide insurance coverage with a steady, predictable premium that cannot be canceled in the long run. This mix allows a whole life product to be competitive in price with universal life prices by, for example, using potential policyholder dividends to acquire additional guaranteed insurance — referred to as paid-up additions. If the investment rate of return is as predicted, the term/whole life mix will be able to sustain a targeted cash value at a lower premium than straight whole life.

Life insurance is almost always a consideration when developing a succession plan. Moreover, as new succession alternatives are developed, old insurance needs may become obsolete, while new insurance needs may arise. The following discussion of various insurance alternatives illustrates some of the different roles that life insurance may play in succession planning.

Income replacement

The primary reason that many people buy life insurance is as a replacement for income streams from deceased wage earners who supported their families. This need is sometimes overlooked by such wage earners who were business owners when planning for succession. This is because many owners plan to bequeath the business to their family members and assume the family members will continue to reap the same cash flow from the business after death. This reasoning does not account for the fact the family will lose the income stream from the deceased's salary. That salary must now go to someone else who is now performing the duties of the deceased. If the replacement employee is not a family member, the cash flow provided by that salary is no longer family income.

Life insurance is almost always a consideration when developing a succession plan.

Estate tax liquidity

As discussed earlier in this volume, life insurance is a widely used financial tool for paying estate taxes upon death. Often, the estates of closely held business owners are comprised significantly of illiquid property. This may cause a severe liquidity crunch when the estate tax comes due. Insurance policies on the lives of the business owners may provide the liquidity needed to help pay estate taxes.

Key person insurance

Key person insurance provides businesses with protection in case one of the key employees dies. The business generally makes the premium payments, and is the beneficiary of the policy. The premium payments are not deductible for income tax purposes, and the death benefit is generally excluded from taxable income of the business. Exceptions may exist for companies subject to the alternative minimum tax.

Key person insurance proceeds may help a company transition through the financial and other difficulties that might occur when a key executive dies. Bank loans can be paid down. A stronger balance sheet (with cash reserves and less debt) can help creditors, customers, shareholders, and employees feel more secure in the ability of the company to remain viable. If sales decline temporarily, the company will have additional cash reserves to continue through the rough times. Finally, the insurance proceeds may be used to help recruit and train the deceased executive's successor.

Funding a buy-sell agreement

The death of a closely held business owner is often a triggering event in a company's buy-sell agreement that mandates the purchase of the deceased owner's shares by the company or the other shareholders. Life insurance is commonly used as the funding source to pay for such a purchase. Typically, buy-sell agreements are designed as either redemption agreements (the company buys the stock from the deceased shareholder's estate) or cross-purchase agreements (the other shareholders buy

the stock from the deceased shareholder's estate). If the buy-sell calls for a redemption, the company may consider purchasing adequate life insurance coverage on the lives of all the shareholders. If one of the shareholders dies, the proceeds from the life insurance policy may be used by the company to purchase the stock from the deceased shareholder's estate. If the buy-sell agreement calls for a cross-purchase, all of the shareholders may buy insurance policies on the lives of all the other shareholders. In the event of the death of any one of the shareholders, the surviving shareholders may use the proceeds from the life insurance to buy the stock personally from the deceased shareholder's estate.

Compensation

Life insurance can also be used to enhance employee compensation packages. A common example of such a strategy is accomplished by setting up a split-dollar life insurance plan. In a split-dollar arrangement, the employer and employee split the cost of the life insurance premiums on the employee's life. Upon the death of the insured, the company receives back what it effectively paid for the policy and the employee's beneficiary receives the portion of the death benefit in excess of the amount returned to the employer.

Life insurance is also commonly used to fund nonqualified deferred compensation plans. Although nonqualified deferred compensation plans do not have to be structured with life insurance, employees find it reassuring when their plan benefits are reinforced by the existence of a life insurance policy. Typically, the company will buy an insurance policy on the life of the employee, naming the company as the beneficiary. If the employee dies before retirement age, the insurance death benefit is used by the company to pay the obligation under the nonqualified deferred compensation to the deceased employee's heirs. If the employee lives to retirement age and cashes out the balance in the nonqualified deferred compensation plan, the company can use the cash value in the policy to help fund the obligation to the employee under the plan.

The life insurance policy review

It is advisable that your succession planning advisors include independent insurance advisors. They work with your insurance agent to coordinate the right mix of insurance products with the technical recommendations to be implemented to help business owners and individuals avoid common insurance problems.

Periodic examination of insurance policies is prudent as family and business situations change. Possible unaddressed insurance issues include:

- Children and grandchildren are born, married, and divorced, requiring insurance restructuring
- Beneficiary designations may not be current
- Beneficiaries on policies sometimes predecease donors; therefore, policy ownership may not be structured in the most tax-effective manner
- Ancillary documents (such as split-dollar agreements or buy-sell agreements) may not be properly in place
- The current mix of insurance products may be inappropriate or overly expensive

Investment strategy

As a business owner, you face special challenges when it comes to managing family wealth. It takes so much time and energy to stay on top of business operations that it seems there's little bandwidth left to manage personal investments. So you may defer investment decisions to a broker or money manager. Experienced help definitely has its benefits, but your personal attention is still a necessary ingredient for your investment portfolio to reach its potential. No one knows better than you how to make sure your investment strategy aligns with your family's goals or those of the business.

Investment diversity also presents a special challenge for closely held business owners. Growing a business requires capital. During periods of growth, many business owners answer part of the need for capital by reinvesting their profits in the company. If that sounds familiar to you, that concentration may keep you from accumulating the kind of large, diversified personal investment portfolio most investors try to build. That means investment planning ends up relatively low on your list of priorities — and that you have fewer options to plan around in the first place.

Coordinating succession planning, investment planning, and monitoring

Managing wealth should be integral part of any comprehensive succession planning process. To successfully anticipate and plan for future needs, investment advisors must understand their clients' attitudes and competencies:

- Overall investment goals and objectives
- Personal risk tolerance
- Level of knowledge relating to investing
- Current investment strategy
- Current investment portfolio

To offer effective counsel in a succession situation, investment advisors must also have a clear command of these important issues:

- The tax ramifications of the technical aspects of the succession plan
- The practical and financial ramifications of the technical aspects of the succession plan
- Short-term and long-term individual liquidity needs
- Possible future business concerns, such as financing or capital obligations
- Estate planning and birthright issues between heirs working in the business and heirs working outside the business
- The founder's retirement plan, estate plan, insurance needs, and income tax situation

This information may have a direct effect on investment decisions. That's because misunderstood tax issues or unanticipated cash needs can certainly derail investment strategies. Based on these factors, a sound investment consulting process should generally entail four basic steps:

Assessment

The investment advisor will assess the current portfolio, investment strategy, and risk tolerance, then provide education on investment principles and on how an investment plan can relate to specific financial goals. When assessing the investment needs of the business owner, the investment advisory specialist should work to understand and account for all of the elements of the comprehensive succession plan.

Analysis and recommendations

The investment advisor will develop asset allocation models and help draft an investment policy statement.

Implementation

The investment advisor will provide information on money managers, and will help identify money managers who are ready to work within the bounds of the investment policy statement developed in the analysis and recommendation phase.

Monitoring

On a periodic basis, detailed summaries of portfolio holdings and transactions, portfolio performance reports, and ongoing supervision of investment policy should be provided.

An investment advisor who understands all of the components of the succession plan may better account for income and estate tax complications, retirement needs, or other special cash requirements. The hope for every retiring business owner is to experience seamless coordination of the plan by an investment advisor who is independent, tax sensitive, and understands the succession plan.

In summary

Neither succession planning nor retirement planning happens quickly. You've probably spent years preparing for both. If you're like many business owners, though, you have a penchant for putting the needs of the business ahead of your own. That may have meant prioritizing daily operations and eventual succession over securing your own wealth. Besides, it's human nature to put off such things — and in that respect, owners are no less human than their employees.

The future of the company and your future personal finances are closely intertwined. They'll remain linked even after your last day on the job. But intertwined doesn't mean identical. It's time to give full, distinct attention to preserving and enjoying the rewards you've spent a career earning.

On any given day, a personnel decision or a supplier contract or any of a thousand other things can alter your priorities and persuade you to leave long-term decisions until tomorrow. In financial planning as in business, don't let the urgent crowd out the important.

Everyone plans for retirement, but the process is different for business owners. You can and should rely on professional counsel for both the succession process and the retirement process. You should certainly insist that the advisors you use in each case pay attention to the other side of the equation and work toward alignment. But the ultimate responsibility for making it all work rests with you.

The details are profound, the pitfalls many. But you've faced those odds before. It's how you got here. This is the time to see it through.



CASE STUDY

The following scenario is based upon experience with actual family businesses. It is intended to illustrate the importance of paying attention to the nuances of tax, insurance, and estate law.

Two businesses, two different planning outcomes

The two businesses grew side by side for decades — a restaurant and a hair salon. Both had started as family affairs, but over time they had each brought in more non-family members, first as employees and eventually into management roles. The restaurant added two locations and the salon expanded into a full-service day spa. Their owners were old friends and sometimes stopped to talk shop with each other. Now, retirement drew near for both.

Carmen couldn't believe he was soon going to be going to bed and getting up at "civilian" hours without having to meet delivery trucks, micromanage a kitchen, greet patrons, and handle the books. He knew better than to buy into his friends' exclamations that the restaurant "must be a gold mine!" but he had managed things carefully over the years. He knew there was enough to carry him and his wife through retirement and to give his children a sound legacy.

Alicia never had to work the crazy hours Carmen did, but she'd always been the face of the salon and seldom took real vacations. Even in retirement she planned to remain a fixture in town. But she had her eye on a property adjacent to hers, and plans for a bigger home where she could sculpt, host big family holidays, and maybe put in a pool.

Only two years into his retirement, Carmen unexpectedly died. His wife took comfort in knowing he'd made plans to provide for her. The first surprise came when Carmen's life insurance policy paid out: Because the policy had been under Carmen's ownership, it was taxed at the 40 percent federal estate tax immediately. His wife was left the sole

proprietor of a thriving business, but its assets were mostly illiquid. Meanwhile, the sums Carmen had bequeathed to his children weren't protected from estate tax through any trusts or other structures, and because of tax rate changes over time, they were also taxed and lost a lot of their value. Carmen's widow will be able to support herself, but to do so she faces a hard choice: either sell the restaurant — or take over Carmen's old podium at the front of the house every night.

Alicia has made planned annual gifts to her children and grandchildren that fall within allowable limits. She has also structured trusts for the grandchildren that will activate upon her death. She named her brother and a local law firm as co-administrators of the trusts, so her heirs will have the benefits of both family involvement and institutional permanence. This will prove sadly prescient when her brother dies before some of the grandchildren reach majority. And while much of the capital she received upon selling spa and salon to a regional chain has been sunk into her real estate dreams, she has also used it to fund a balanced, well-structured portfolio of more flexible investments, including stock in the company that bought her out.

Both Carmen and Alicia planned for retirement and succession with all the diligence they'd brought to building their businesses. The difference between their families' experiences had nothing to do with effort or care — it had everything to do with attention to the nuances of tax, insurance, and estate law. What both families learned in the end was that the fine print looms large.

Volume 5

Family dynamics and governance

Shared purpose? Or cross purposes?

Succession planning is an important consideration for all companies, but for family businesses, there is an added layer of complexity. Throughout the years, a family business serves two masters whose priorities aren't always the same. And when it's time to pass the reins, the interplay between business strategy and family dynamics holds the potential for real conflict. The fortunes of the company and the status of the family are both at stake.

Like every other aspect of business succession planning, the question of family dynamics and governance is best addressed over the long term. This is a process, not an event. Years before an actual change of leadership, the owners of a family business should consider making clear determinations about its stakeholders, its obligations, and who controls what. For many businesses, these are just decisions. For family businesses, they may prompt the creation of entirely new governance structures.

There's more to this than avoiding trouble. A thoughtfully governed family business can be a boon for everyone involved — not only in terms of wealth creation, but also in promoting harmony, personal fulfillment, and shared purpose. It's no accident some families build their professional lives so close to their personal lives. Good governance can help the business and the family prosper together.

Family business challenges

Left to themselves, business concerns and family concerns can interfere with one another. Even with a clear boundary in place, family businesses and their owners should consider most succession planning issues from both perspectives. When it isn't clear which agenda is driving things, the decision-making process can become confused and inconsistent. Family relationships deteriorate, business success suffers, and the succession plan may be derailed.

Communication, or the lack of it, can be a significant issue for families in business. The family business is often the primary source of family income and future wealth, so every family member likely will be affected by the business operations and succession decisions — including the ones who have no formal employment or leadership role in the company. Since all family members may have or want some degree of interest in the direction of the company and expect to have a voice, the succession plan can take this into account.

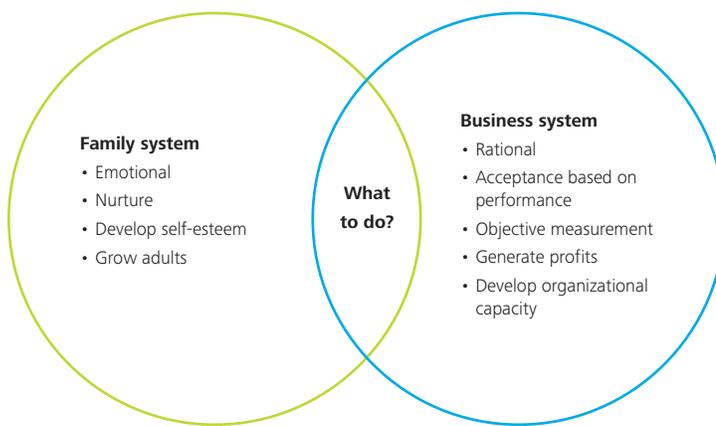
Family business models

More than four out of five family business owners believe their families will retain control of their businesses five years from now, but in reality, only about 30 percent of family businesses survive into the second generation, 12 percent into the third generation, and 3 percent beyond that.³

Several “business models” have been developed to better understand the inherent complexity within a family business system. The models focus on the interplay of family concerns and business concerns. They may appear somewhat simplistic at first, but can be very helpful in understanding the relationships and motivations of the individuals within a family business. Families that examine these models and apply one to their personal situations are often surprised by the help they provide in identifying potential areas of conflict.

³ “Succession Planning.” Family Business Institute, n.d. Web. <<http://www.familybusinessinstitute.com/index.php/Succession-Planning/>>.

Figure 2: Two-circle family and business system model



Analysis of family and business systems

For every family business, two systems coexist and in some respects compete with one another: the *family system* and the *business system*. Research by family business experts has led to the conclusion that many family business problems can be traced to situations where the family system and business system are in conflict.

The family system

The family system is based on emotion and love, and its key purpose is to nurture and develop self-esteem in younger people so they may grow into emotionally mature and responsible adults. Admittance and acceptance are unconditional and based on relationship alone. The emotional nature of the family setting has a number of effects. While the family system celebrates successes just as any other system does, it can also react to failure in more loving and benign ways. The underperforming family executive may get consolation and encouragement not unlike the Little Leaguer who strikes out too often — a stark contrast to a purely professional environment. On the other hand, when conflict arises amid the emotions of a family environment, it can escalate more quickly.

The business system

The business system exists to address the needs of its customers, generate profits, increase shareholder wealth, and develop organizational capacity to function and grow. Many businesses, regardless of organizational type, embrace philanthropic or community-building roles as well. In a business system, organizations address these issues in a rational and analytical fashion. Admittance and acceptance in a professional environment generally depend on skill and performance — so in contrast to the warm treatment for a skill-challenged Little Leaguer, the more apt comparison is to a professional baseball player who risks being cut from the team if he strikes out too often. The path to promotions and salary increases requires home runs, no matter what the player's last name may be.

The family system is distinct from the business system, but as seen in Figure 2, the two systems overlap in many areas. Family issues, tasks, or motivations are placed in the family circle. Business issues, tasks, or motivations are placed in the business circle. The overlap of the two circles illustrates the difficulty that emerges when the competing systems collide.

Consider an example: The patriarch of the family is contemplating the promotion of his son to vice president in charge of sales. Using the model in Figure 1, the family circle will likely consider the promotion to be a positive action because it will likely help develop the son's self-esteem, allow for father and son to develop a closer working relationship, and provide more salary to the son, enhancing the quality of life for the owner's child and grandchildren. However, the business circle may indicate that the son is not experienced enough for such an important role in the company. Customers may be unhappy with service. And valuable long-time employees may resent what they see as nepotism. Identifying potential inherent conflicts — where positives in the family system are simultaneously negatives in the business system, or vice-versa — is the first step for family business owners whenever they face a difficult decision that affects both systems. Once they sort out and analyze the issues, they can devise a solution that serves the business concerns while accounting for the family issues.

Family first or business first?

Some business owners put the family system ahead of the business system. They operate under the premise that family members have a right to express themselves under any circumstances, no matter how ill-informed or disruptive their actions may be. In an extreme example, company management is fully accountable to every single family member on any issue at all times and it is the birthright of all family members to enter or exit employment in the business as they choose, and at the same pay rate as the other family members, regardless of experience or contribution to profits.

These practices may eventually undermine the competitiveness of the business. They could also interfere with a reality-based view of the business; for example, if the family grows and everyone is entitled to participate in the company, the expenses of the company may grow in a way that can't be supported by its true profit-and-loss performance or market potential.

Conversely, other business owners put business issues ahead of family. They do not formulate plans just for the purpose of developing skills and experience in younger family members or grooming them to succeed in the business. In some instances, the promotion process for

family members is more difficult than for others. Again in an extreme example, these owners assume until proven otherwise that every family member's opinion is always incorrect, uninformed, and disruptive to management. This approach may suppress the individual development and self-esteem of junior family members, and may make it harder for the full potential of the next generation to flourish. Family resentments could fester into conflict that destroys interpersonal relationships and tears apart both the business and the family.

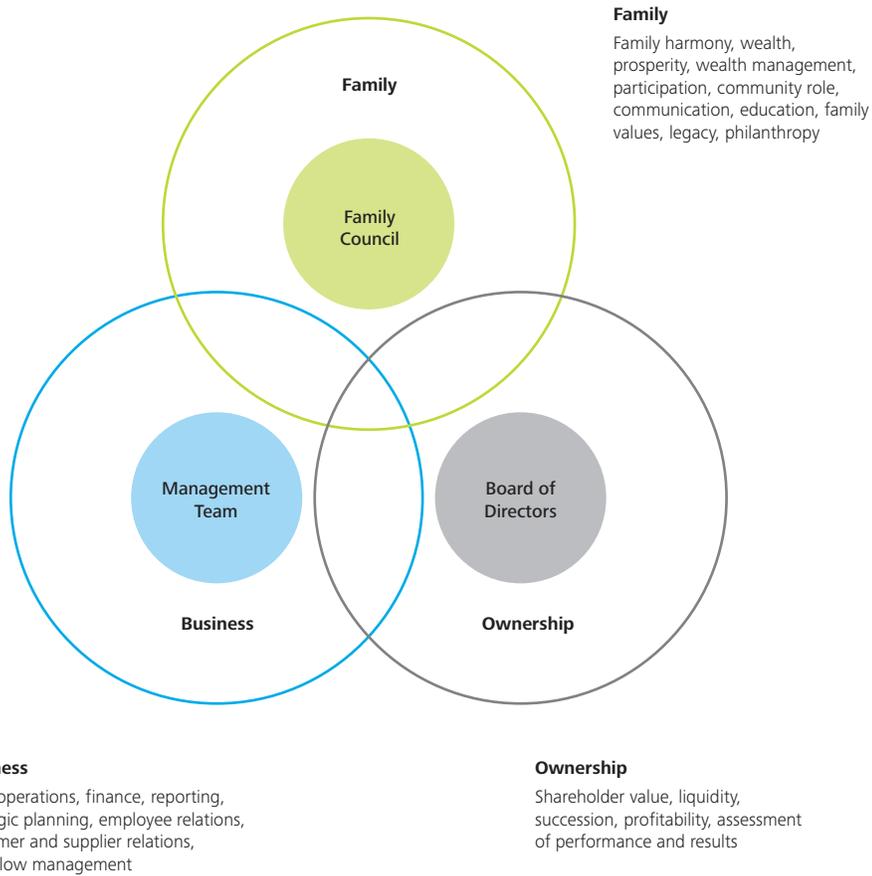
While those examples are theoretical extremes, in reality, the family and business systems are equally important to the long-term success and prosperity of a family business. Neither should be neglected. When devising a succession plan, leaders should consider granting equal respect and consideration to both constituencies.

There is an expanded model as well (the "three-circle" diagram in Figure 3) that recognizes ownership as an added dynamic for which one must also account. Family members who have ownership in the company may have different motivations from family members who do not. Likewise, non-family employees with ownership may tend to have a different frame of reference from that of comparable non-family employees without ownership. It is not uncommon to find owners of a family business who are neither employees nor family members.

By plotting each individual family business stakeholder in the three-circle model, it becomes evident which ones will theoretically have similar interests. For example, shareholders who are not employees would presumably share similar opinions regarding such issues as dividend policies, family pay scales, feelings of legacy, composition of board members, or adequacy of communication. Stakeholders who are employed in the business may have very different views on the same issues.

To illustrate this point, assume that as part of its succession plan a family business reorganizes as a Subchapter "S" corporation for tax purposes. As a result, the company must revise its dividend policy. By placing all the stakeholders in their respective circles within the three-circle diagram, the patriarch of the family business may be able to anticipate how different individuals may think about the new policy.

Figure 3: Three-circle family and business system model



- The business owners who are not employed in the business may want to increase the payment of cash dividends to shareholders. Since the income of the “S” corporation flows through to shareholders, they need the cash to pay taxes.
- The owners who are employed in the business would likely prefer to pay large incentive-based, year-end bonuses to reward employees for business success.
- And the non-family managers without ownership may want to reinvest profits into the company to help finance expansion plans and keep the company’s debt-to-equity ratio at a healthy level.

The three-circle diagram helps the stakeholders understand that their individual perspectives are inherently different due to their position in the family business system.

One of the challenges for family business owners in succession planning is to deal effectively with a myriad of business and financial issues such as ownership transition, management development, retirement planning, tax planning, and strategic direction while managing the emotional condition of all of the stakeholders throughout the process — which may be the most difficult aspect of all.

There are tested strategies and methodologies that may help family business owners through this process. One of the more prominent of these strategies includes the implementation of formal family policies and governance structures. Enhanced understanding promotes empathy and trust, which leads to compromise and resolution. Communication is generally improved and the ability of the business to preserve shareholder value is sustained. At the center of communication and understanding is transparency. Family businesses can keep problems from taking root if everyone is informed and honest about goals and decisions.

Information, communication, and governance

Many difficulties associated with succession planning can be traced to inadequate communication among key stakeholders in the business. Businesses of all types can help address these difficulties through the use of formalized governance structures that open the lines of communication. This is especially the case for family businesses, which can employ family business governance structures designed to separate the “business of the family” from the “business of the business.” This division can help on both fronts — driving company profits while maintaining family harmony.

Outside board of directors or board of advisors

Many owners of privately held businesses fail to take full advantage of the benefits formalized governance structures can provide. In particular, a business that doesn’t have a functioning board of directors or outside board of advisors may be missing out on a tremendous opportunity to improve management and profitability, especially during a period of transition.

An outside board, composed of individuals with years of business experience, can be a strategic asset by providing the business owner with valuable advice. These board members likely will make recommendations on what they

believe represents the best interests of the shareholders and the company. Indeed, their relationship with the company imposes a fiduciary responsibility — a “duty of care” and “duty of loyalty” — to uphold those interests.

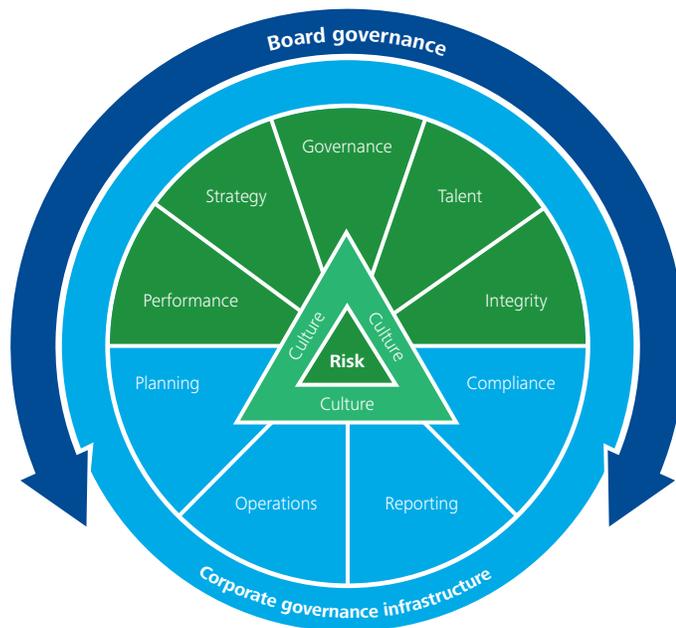
Outside directors and advisors can also help play an important, objective role in the implementation of a management succession plan. One area where a board has an impact on succession is in its role of identifying candidates to take over as CEO — and in working with the current CEO to carry out that process. Board members can help assist in identifying possible successors from the pool of candidates and serve as mentors for successor candidates. They may also advise on the broader talent plan and help with the implementation and monitoring of the management talent assessment and the management development plan. The board may provide oversight of the plan, determining that the process remains untainted and consistent.

Approaching succession with reliance on outside directors or advisors can also help defuse family conflicts. If the founder-owner is perceived to be the sole decision maker in succession matters, emotional ties and demands for personal loyalty can cloud determinations of skill, experience, and potential. When a board picks a successor, no one is left wondering which family member the board “loves more.”

In addition to having ultimate responsibility for the CEO succession planning process, the board can help to monitor and improve business management. Figure 4 is the Deloitte governance framework diagram that can help business leaders visualize the different roles that a board, a management team, and a governance structure oversee. They all function in concert with one another — and business succession planning is part of the “talent” function in the upper right.

As the governance diagram indicates, an infrastructure of sound governance encompasses all company activities — from the operational to the strategic — but the work of the outside board focuses more on high-level strategy questions, including talent and succession planning. Everything takes place around a core of culture and risk awareness.

Figure 4: Governance framework



While a functioning board of directors should have real powers, a first-generation entrepreneurial owner may not have the need for an outside board. In its early stages, the business structure and management hierarchy are simple: the entrepreneurial owner does everything. Even if the owner wants to continue that hands-on control as the business grows, there is still room for outside counsel. In that case, a board of advisors — which offers wisdom on a non-binding basis — is an attractive alternative to a board of directors that is actually empowered to command and overrule the founder.

But as the company grows, circumstances likely become more complex. With business success comes more employees to manage, more processes to oversee, more relationships to cultivate, and more financial information to track and evaluate. As the company begins to outgrow some of the old ways of doing things, the owner’s role begins to change. More and more of the owner’s time is

spent performing high-level managerial and relational tasks and less time is spent “in the field.” As the company grows and becomes more complex, the value and importance of an independent group of outside board members likely becomes more evident.

Organizing and recruiting an outside board of directors

Typically, the leading candidate for a board member is a knowledgeable, experienced, and impartial outsider. Retired or active CEOs with experience owning or managing privately held businesses are often ideal. Some companies seek outside board members with specific areas of expertise to add to the mix, such as finance, law, audit, or human resources.

Setting up an outside board of directors is a complex process that deserves a guidebook of its own. For our purposes, the following brief guidelines illustrate how the process might work.

Develop a statement of purpose for the board. The business owners should meet and decide what role the board will play vis-à-vis company management and ownership. The end result of this process is a written, overarching statement of purpose for the board.

Decide on characteristics of the ideal board members. What kind of experience do you want to see represented on your board? A good starting point is to construct a board skills matrix that helps you align the skills and experiences the company will need with the available candidates. For example, if the company is planning to expand sales or operations into foreign markets, it may seek board members with international experience. If the company is planning a significant investment in the digital realm, it may recruit an individual with social media or e-commerce experience. Experience in the company's industry, or a similar industry, are often prerequisites. Age, gender, ethnicity, and other aspects of diversity may be a consideration if that will help the owners represent the values of more than one generation and better reflect the marketplace the business serves.

Prepare a board prospectus. Some businesses prepare a document referred to as a "Prospectus for the Board of Directors," which is used later in the process to help recruit board candidates. The prospectus explains the purpose and goals of the board. Further, it lays out the structure, time demands, fees, and meeting schedules. Finally, it describes the capabilities, qualifications, and characteristics sought in board members.

Network to identify possible candidates. The business owner's first instinct is usually to invite valued counselors, such as financial advisors, attorneys, or bankers — or just old friends — to serve on the board. Yet business owners are typically better served by recruiting fellow business owners, entrepreneurs, business peers, and retired CEOs or CFOs to fill board positions. Individuals like these are more than advisors. They may have already faced some of the hurdles that lie ahead for the company and can offer advice from the experienced perspective of a business owner. Company advisors will often serve as an excellent source of referrals. If a prospectus was prepared, include a copy with your request for referral.

Meet with candidates. When the business owner or owners interview the board candidates, they can explain the company's needs and ask each candidate what qualifications will help them meet those needs. Some business owners have a trusted advisor such as a succession planning consultant present during the interviews to help with the process. Always be certain to check references. Seek out people who know the candidates and find out about their character, personality, and professional histories.

Solicit support from owners and managers. Before inviting a candidate to join the board, have him or her meet all of the shareholders and key managers to make sure all applicable parties are comfortable with the match. Owners and managers of the company should have a forum for expressing their opinions about the candidate — both positive and negative — and the business leaders should have veto power.

Family governance

Governing the business side can be daunting, but it's a challenge common to many enterprises. In succession planning and elsewhere, the family-held business faces the dual challenge of managing business decisions, family needs, and the complex ways they intersect. The "business of the family" and the "business of the business" are equally important, but they are sometimes at odds. This is because the principles of the business functioning are often different from the principles of the family functioning. Once again, the solution may lie in specific structures that help identify, distinguish, and pursue the right priorities.

Concept of a family council. A traditional board of directors governance structure does not generally account for the family dynamics described above. Through the creation of a unique family governance structure, called a family council, family businesses — in conjunction with a traditional corporate board — can help improve communication, transparency, accountability, and family harmony. Participation in a family council lets all the stakeholders feel that they're part of the family/business system in Figure 2 (see page 51), whether or not they work in the business. In a family council setting, family issues are addressed separately from business issues — instead of being inappropriately exposed in front of non-family board members or managers. Lines of communication remain open. Interpersonal relationships are improved.

What is a family council? A family council serves as a formal, selected group of family members to protect the interests of the family. Just as a corporate board protects the financial interests of the shareholders, a family council protects the growth, development and welfare of all the members of the family. However, unlike a corporate board, it does not have fiduciary responsibilities. And just as protocol in a corporate board meeting is determined by the corporation's articles of incorporation, by-laws, and shareholder agreements, protocol in a family council is determined by a family charter, meeting ground rules, and a vision and mission statement. A family council provides family members with a regular, structured forum to make agreements, communicate, and decide on the proper role of the family members in dealing with family business.

Setting up a family council. A trusted advisor, such as a succession planning specialist, can help organize the family council. Sometimes the family council is organized along with an outside corporate board of directors. The advisor may attend the first few family council meetings to observe and make recommendations. After the family governance structures are in place and operating, the need to include the advisor will likely diminish and eventually disappear. The mature family governance structure (outside board of directors and family council) will be operating fully with family members and business owners controlling the activities.

The process usually follows a number of common general steps:

- Call a special family meeting to explain the family council concept
- Develop a family statement of vision, mission, and core values
- Develop a family charter
- Set a schedule for general council meetings
- Elect family council officers
- Assign responsibility for council subcommittees
- Begin to conduct the meetings

Who may participate in the family council? A voice and a vote on the council is a privilege to be earned, not an automatic right. This does not mean younger family members should be prohibited from attending general family council meetings, but they should be old enough to conduct themselves in a mature manner. It is advisable to permit young family members to attend family council meetings as soon as they are able to sit through without being disruptive. This is a way to condition the next generation of the family to know, respect and work with each other. It also helps educate the younger family members about the family's history, traditions, and role in the community. In this sense, the mere existence of a family council may help to instill the family's core values in the next generation from a very early age.

A family council: common functions

A family council operates separately from, but in coordination with, the board of directors. The family council is designed to deal with the business of the family, while the company board of directors is dealing with the business of the business. There should be at least one liaison between the corporate board and family council.

The family council also provides a regular time and place where people can discuss the family interest in the business — and discuss family matters in a protocol that can resolve misunderstandings without escalating them to involve the business.

The family council contributes to better family relations by providing a mutual support system during difficult

times. Council meetings may serve to help maintain the health of family members, foster community involvement, or educate family members on financial and other issues.

A family can also establish and maintain a family fund — in short, a sort of “mini-bank” that can support family projects, family members' entrepreneurship, or loans. A family fund is managed by the family and is distinct from the business, which protects the financial status of the business from non-business related activities and gives the family more flexibility in non-business transactions. A family fund may exist alongside a family council or in the absence of one. Or it may predate that structure.

Family statements of mission and vision

Every family's expression of value will be different. This is one example of what such a document might include.

Vision

To be a close-knit, strong family whose core values encourage the development of healthy, happy, competent, educated, and independent individuals who enjoy working together for the common welfare of their families, business enterprises, and community.

Mission

To build a cohesive and enduring family organization that promotes and embodies the family's core values based on a foundation of:

- Open communication
- Honor and respect for each other and the family name
- Integrity and trust
- Education and personal development
- A strong work ethic in matters of business
- A commitment to the community

That said, younger family members should still understand that they have to meet certain criteria before participating on the family council with their elders. The family will determine those qualifications when it drafts the family charter. They may include excellence at one's chosen vocation (inside the company or elsewhere), financial responsibility, literacy in business language and the ability to interpret financial statements, trust and respect of family elders, and the ability to handle disputes in a mature manner.

When a younger family member steps up to become a full-fledged council member, it's a watershed event in that person's life and career. Some family businesses meet the event with fanfare. Some families have annual retreats where the first order of business on the retreat agenda is always admittance of new council members. The new council members are honored and welcomed in a special ceremony during the retreat. This tradition can evolve into an important family rite of passage into adulthood for family members. It also motivates the family members to attain the family core values in order to earn that special rite of passage.

Family offices

Successful closely held companies and family businesses can evolve over generations from entrepreneurial start-up organizations into large, professionally managed corporations. As a closely held company grows, it should consider developing improved management processes and hire experienced professionals. Skilled professional managers help the owners with strategic direction, finance, accounting, tax, human resources, information, technology, operations, sales, and research and development.

As a business evolves and the branches of the family tree spread, more family members may inherit ownership and the number of company stockholders can increase. In just two generations, the number of shareholders in a closely held company can easily grow from two to 30.

Often, these family members find themselves owners of a highly profitable, professionally run organization that is generating significant profits and making significant distributions in excess of the family members' needs. In some cases, the company is acquired or goes public, and the illiquid privately owned stock is transformed into cash or publicly traded stock. In either instance, the family members may have liquid wealth to manage. At this point, the family needs to consider the establishment of a family office.

From a succession planning perspective, a family office can serve two roles. First it can help hold the family together. As the family business has grown, it's likely the company has served as the "glue" that keeps family members on the same page physically ("we grew up over the store"), financially (because of the unified financial interest) and perhaps even emotionally (for many families, the family business is the family alter ego). As family members' ongoing involvement in the family business decreases, either because of a sale or because of a transition to an outside management team, the family office can replace the family business as the unifying organization.

Second, a family office can keep personal and family interests separate and distinct from company interests — while still providing family members with best-of-class services. Through the family office, they can manage their access to non-company investment options and arrange for a diverse set of financial and personal services. The family office can serve the needs of the family without diverting business resources. It is also worth noting that the IRS does not look favorably on non-business-related services which are provided by a business, oftentimes recasting them as taxable dividends. Providing those services through a family office can avoid that situation.

Successful closely held companies and family businesses can evolve over generations from entrepreneurial start-up organizations into large, professionally managed corporations.

A family office is a professionally managed financial organization. The family office will likely employ a management team that can include a chief executive officer, a chief financial officer, a chief investment officer, and a staff of accountants and administrative assistants. Their primary role is to manage family affairs and wealth in a professional manner. A family office has governance structures just like a board of directors or family council, but in this case many of those positions will likely be populated by family members. Like its business counterpart, the management team of a well-run family office might report to a board. The family board or family council may meet regularly, and oversee family office activities. At these meetings, family members receive reports from the family office management regarding the family wealth and other family-sponsored activities. In board meetings, family members typically discuss a wide variety of issues such as investment strategy, charitable activities, performance of family office staff, purchases or sales of significant family assets, estate and gift planning, family publicity and privacy issues, or any other topics that may be important to the family.

The purpose of the family office is to protect family wealth and promote harmony. It does so by applying sound business practices and theories to the management of the family's personal wealth. As generations pass, more and more individuals become stewards of the family wealth and tradition, both individually and, in many cases, as fiduciaries (many of the same families employ trusts to hold and transfer wealth inter-generationally, and accordingly many act as trustees for those trusts).

That elevates the potential likelihood for conflict or mismanagement of wealth. When properly organized and staffed, a family office can provide structure and controls to maintain rational, objective, and forward-looking processes. By employing skilled professionals who devote their full attention to the protection and growth of family wealth, and who are accountable to family members, the family can reduce conflict or mismanagement.

The family office also centralizes and manages the administrative functions of the family, including the reconciliation of bank and investment statements, payment of bills and taxes, preparation of financial statements, execution of investment strategies, dealing with insurance needs, management of tax compliance for all family members and related entities, maintenance of confidential records in a central location, and anticipation of possible future administrative needs. Provided that the family agrees, a family office may also provide other services, such as coordinating travel plans for family members, hiring household help, managing the family's properties — there really is no limit to the offerings.

As a successful family business transitions and the roles of future generations of family members evolve, many families have determined that a family office can play a significant role in a well-developed succession plan. Often the policies and structures an owner puts in place today, such as the establishment of a family office, likely will lay the foundation for a successful and harmonious lifestyle and preserved family legacy for generations to come.

The purpose of the family office is to protect family wealth and promote harmony.

In summary

For an enterprise that may have begun at a dining room table or in a garage — one in which positions of responsibility may still coincide with relations of blood or marriage — the idea of introducing formal structures may appear intimidating or unnecessary. Let alone the prospect of multiple, overlapping structures that may include some combination of a board of directors, board of advisors, family council and a family office to exist alongside the daily management team that's already in place.

No matter how daunting they may appear, these are important steps that reflect the growing maturity of the business. Setting up these governance structures may seem complex, but if you want to see real complexity, watch what happens if you don't. The intersection of company needs, family needs, and marketplace realities is a potential breeding ground for confusion and conflict. You don't want to plan for the future of your business, or contemplate a succession strategy, without a plan to navigate that confluence.



CASE STUDY

The following scenario is based upon experience with actual family businesses. It is intended to illustrate how good governance practices — or the lack thereof — can impact future outcomes.

Two family businesses on different paths

Good governance decisions can unlock the long-term vitality of a family business — and poor ones, or none at all, can lock a family into years of conflict and potential demise. Consider the hypothetical case of two family businesses that took sharply different approaches to the challenge.

José, an entrepreneur with only a primary education, was the founder of an energy company. As the company matured and his sons grew over the years, José eventually held 31 percent of the shares. His son Lorenzo, an active participant in the business, held 29 percent, and his other sons Alejandro and Emilio owned 20 percent each. All the while, the business went through a gradual evolution to more sophisticated management and internal structures.

As José aged, Lorenzo sought to solidify the company's future by establishing a formal corporate governance model. Finding the right specialists and formalizing the ideals that would guide the organization was challenging.

Perhaps the biggest initial challenge, though, was getting father, founder and dedicated traditionalist José to go along. This was the first time anyone outside the family stood to have a say in the company's direction. Based on his track record as a top executive, Lorenzo was able to convince José it was time.

Initially, the move toward formal governance included only a board of directors made up of shareholders. Soon, the company brought on external corporate governance consultants and finally appointed a professional CEO — not a family member, but an executive employee of long standing.

The transition wasn't without awkward moments. Some of José's informal and not entirely appropriate administrative techniques came to light and had to be adjusted. As the principle of good governance gathered momentum, the company adopted new policies and practices. It also set forth a formal process to plot the eventual CEO succession. Eventually, the company that had begun at José's dining room table had an independent board and an audit committee.

José was still active in the business, but now he got to take vacations. His other sons had time to learn the business on a formal footing, and he was able to make planned transfers of his ownership stake in a way that preserved business value. A new trust was in place to help facilitate the family's future prosperity.

Today, the sons are the company's day-to-day leaders. José drops in now and then, and attends board meetings, but he also travels the world knowing his business and family legacy is secure.

In marked contrast, our other story concerns a tourism business with operating units in several states. The majority shareholder and sole head of the business, Jerry, has a wife, two sons, and two daughters. His children were all married. Only Edgar, his older son, worked with Jerry in the family business.

Without warning, Jerry had a brain seizure and died at age 65. Edgar immediately took over as CEO, but Jerry's widow, who never had any interest in business, inherited a 95 percent stake in the company. The four adult children shared equally in the remaining 5 percent — and with different interests, and different understandings about what the company meant to them, it wasn't long before petty rivalries erupted into open conflict.

Edgar and his brother wanted to solidify the business for the long term. Their sisters wanted their mother's standard of living to be the top priority — a standard funded by cash taken out of the company. The mother wanted family peace but didn't know how to make that happen. She blamed Jerry's poor planning for the impasse the family found itself in.

Turmoil and lack of clear direction took its toll on business performance. Sales fell off, longtime clients turned elsewhere, and the family had to sell off several operating units to keep the business solvent.

After a contentious family retreat, Edgar convinced the family to search for governance specialists and professional C-level business leaders from outside the family. They have agreed to create and empower a board of directors, and an uneasy truce reigns. But considerable damage has happened already, and the family can only hope its belated commitment to governance will be effective in preserving what's left.

Volume 6

Cementing a legacy

Where calculus meets emotion

A lot of effort goes into every part of succession planning. None of it would be necessary if business lifespans and human lifespans aligned perfectly. The whole point of succession is to determine how one of those processes will continue after it disengages from the other. All of which is a clinical-sounding way to express a deeply personal thought: Business succession planning is about what persists of your effort, your stamp, your principles, and your hard work after you are no longer there to continue to shape it.

That's why legacy is such a multifaceted concept to address. What is a legacy? Is it the continuing operation of your business? It can be. Your personal wealth? Your family's wealth? The brand image and reputation you've built? The lifestyles and careers of your children or other successors? Yes to all.

There is no formula a business owner can use to address the emotional side of succession. But there are strategies and leading practices an owner can use to confirm that his or her legacy isn't left to chance.

This capstone entry to the Business Succession Planning series relates what some recognized authorities have shared about legacy. It explores real-world examples of how business leaders have carried those principles into action, and closes with a conversation between practitioners who have first-hand experience helping closely held businesses take on these very challenges.

Thoughts on legacy

This series has emphasized the theme that business succession planning isn't merely about naming the next top leader in an organization. Typically, the conversation has gone on to examine other aspects — technical considerations like tax planning, valuation, and entity structure. But in broadening the discussion from a simplistic "next boss" view to a more nuanced one, a closely held business should not focus solely on the technical.

Family business advisor Leslie Dashew, co-author of *The Keys to Family Business Success*,⁴ has identified seven dimensions of succession, each of which takes place on a higher level than raw tactics:

- Succession of leadership
- Succession of management
- Succession of authority
- Succession of values
- Succession of knowledge
- Succession of relationships
- Succession of ownership

Succession, Dashew advises, is "not just about ownership or equity... It is also a succession of knowledge, relationships, and authority."

What is a legacy? Is it the continuing operation of your business? It can be. Your personal wealth? Your family's wealth? The brand image and reputation you've built? The lifestyles and careers of your children or other successors? Yes to all.

⁴ Leslie Dashew, Sam Lane, Joe Paul, Darrell Beck, and William Roberts, *The Keys to Family Business Success*, Aspen Family Business Group, 2011.

A visit with a veteran

Deloitte Tax LLP partner Tom Plaut, who specializes in succession planning services, has worked with Leslie Dashew over the years. Leslie is a family business advisor and co-author of *The Keys to Family Business Success*. Recently the two connected to explore the meaning of business legacy and how it relates to the broader themes of succession planning. What follows is an edited version of their conversation.

Tom Plaut: Leslie, you've written a lot about the seven dimensions of succession planning in a family business. I'd be interested in getting your commentary around what those seven dimensions are and specifically, which of those dimensions apply to legacy?

Leslie Dashew: Typically when people think about succession they think about succession of leadership or management — and, for estate planning purposes, transition of ownership. But what we found is that many times the succession that is successful has to address four other areas as well. One is succession of authority. In closely held businesses, we find that one of the challenges is the inability of an owner to let go of control.

The challenge is that the owner thinks, “This is my baby! I know it better than anyone else,” and it’s hard to let go. So many times they’ll appoint somebody to be president and vice president with the anticipation that they will succeed them, but not let them make any significant decisions.

One of the reasons someone may not trust the next generation of leadership is because they don’t trust their values. A classic one that we see now is when a younger generation wants balance in life, but they’ve seen the older generation be workaholics. The older generation may say the young ones just don’t work hard enough to keep the business alive.

The next dimension that contributes to this issue is a succession of knowledge. I often hear leaders say the next generation doesn’t know enough: “I’ve built the business, I’ve learned every aspect of the business, and they need to know all of that and if they haven’t created it they can’t know it well enough.”

I also hear leaders say, “I have a number of key employees who have been like family to me; they’re really essential to this business, and I want to make sure they’re taken care of and that they’re retained.” Often the other side is a younger generation who say, “Dad has held on to people way too long.”

TP: You gave the example of the younger generation seeking a different work/life balance than the older generation. How do business owners align values between generations?

LD: Let me divide it in several categories. There are values that characterize the families that stay positively connected over multiple generations and there are values which may be inherent in the business that have been critical success factors. Are we talking about succession of a business that has been an entrepreneurial venture? Or are we talking about one that’s passed from one generation to another already? The most important piece here is to create a container for dialogue or multiple containers for dialogue around values and vision.

Let me start with vision. If a business leader is thinking about the future of his or her business and has a vision of wanting this business to continue to be owned by the family, the first challenge is for that person to engage the family in thinking about what it means to be a family-owned business. In my practice I find that if there’s a shared vision for the future of a business, then there’s a much greater probability that family can continue to own the business.

The second part is: Do they have shared values for the future of this business? Those values may include things such as how we treat employees, what is our role in the community, what are our goals about continuous improvement? How do we view the use of cash, of capital, in the business? Do we look at it as an opportunity to take out money to make the family wealthy? Or do we want to continue to build the business?

TP: Leslie, I believe that you would definitely need to include the key stakeholders in order to formulate a shared vision. Do you agree with that?

LD: Absolutely. If you've been leading a business and you have taken most of the responsibility on your own shoulders, a lot of times it's difficult to engage other people in sharing that responsibility. That's one of the variables that is critical to the success of the succession. If the younger generation doesn't feel that they can have an imprint on that vision, and they don't have the energy or passion for the vision, they're not likely to make it successful.

TP: If I think about the most successful transitions of business that I have been involved with, two key elements present in all were inclusion and communication. Throughout the succession process, the key stakeholders were given a voice and a role in the process. They were able to express their views of the business, their future role, and their personal and professional goals.

LD: One of our colleagues recently said: "If you think about what is magical about a leader, they're able to take energy and create mass." That is, they take their energy, their vision, their passion, and make a business out of it. If the next generation doesn't have that kind of excitement, enthusiasm and energy, then that mass is likely to decrease rather than increase. I've seen many people who don't take their hand off the baton while they're trying to pass it.

TP: I like that analogy — not being able to take your hand off the baton. What are the best ways senior generation family business leaders can deal with the challenge of letting go?

LD: In my experience, somebody who has been a dynamic, engaged leader can't just let go and leave without having something to go to. And if they have had an active, engaged life, they can't just sit at home and read or watch television or play golf. In my experience they have to have something that's compelling that they go to. So the first piece is for leaders to begin to transition their energy long before they plan to let go of the authority. That may mean beginning to cultivate other interests. This is terribly difficult for entrepreneurs in particular, because they're typically consumed by their businesses.

One of the most successful transitions I ever saw was a client who had started a construction business from scratch and built it to a value of \$60 million. By the time he finally sold the business and transitioned it to new leadership, he had started helping a non-profit build its new building. He was on its board, but he had that technical expertise and they really wanted that help. So he was able to take his knowledge, passion, and energy and place it somewhere else.

The second piece is to have the confidence that the next generation will have the supervision — if you will, the oversight — to know they're doing the right thing. So one of the best possible strategies is to make sure that there is an independent board of directors who will provide the kind of oversight and guidance that the departing leader can trust.

When that board is in place, and often the departing leader is on it for a period of time, then there's a sense that, "Okay, I have my nose in and my fingers out, and I can keep an eye on what's going on."

Tom, what have you seen in your experience on this issue of "letting go?"

TP: I believe that the inability of some business owners to transition decision making is one of the key reasons why succession plans fail. There has to be a level of trust that the next leader will make good decisions. There has to be an acknowledgement that the next leader will make some mistakes and will likely make decisions that his or her predecessor would disagree with. And there has to be an attractive alternative present for how the current leader will spend his or her time in retirement. All of these also invariably deal with the challenge of facing one's own mortality.

Leslie, when is the best time for a business owner to define and articulate a legacy?

LD: Legacy has many different connotations. Entrepreneurs are busy building something that is not there, so they typically are not thinking about their legacy. They're thinking about what they're creating surviving, building it. So for an entrepreneur that developmental stage begins later than it does for some other people. And at that point they begin to think about this asset base that they've created.

But for other people it becomes something broader, and that's what we might call a spiritual legacy or a set of values. One of the traditions that I've seen has been very helpful is something that comes from the Jewish religion called an ethical will. An ethical will is a letter or something that's written that goes into another document, typically a financial will. And it says: Here are the lessons I've learned during my life that have been helpful to me that I would like to pass on to my children or to generations afterwards. When elders are beginning to think about legacy, these messages are really helpful to document. And that's something that business people can do when they're flying from one place to another and they're sitting at 30,000 feet and being reflective. They can begin to write down what those lessons are.

TP: I think that concept has a lot of appeal in a broader context than just business owners and succession planning. I'd be interested in reading one or seeing one.

LD: What's different if you're passing a business on, if you're the second generation or third or fourth, is that the legacy has been started already and handed to you. So you have a different perspective on passing on this legacy, and that thought process starts earlier than for an entrepreneur. If I'm in my family business and I'm second- or third-generation, I'm thinking about what constitutes the legacy I've received. It may be a way of doing business. It may be set of values. I find that that reflection process starts earlier in the life cycle of an individual, a family, and a business if we're transitioning a business that's existed for prior generations.

TP: Sometimes, Leslie, selling a business is the right answer. I have worked with several clients who have had a short-term focus on driving business value for a desired sale. In this instance, the business owner's legacy is not the survival of the business, but rather the survival of the business asset in monetized form.

TP: What does a sustained legacy look like for a multi-generational business?

LD: A legacy includes the tangible and intangible assets that we inherit. The legacy can be the business itself, it can be a tradition, or a set of traditions. Some of them may have to do with one's position in the community. And in some families there's a conscious dialogue that says, "Let's stop and look at the legacy we want to pass on, and what elements of our legacy we don't want to pass on."

When we look at second to third or third to fourth generations, we're looking at how a business can take this asset base, enhance it, and make it relevant to future generations. For example, if your family created the dialing telephone, that's no longer relevant today. But to be in communications would be relevant. One of the challenges when you have a mature business is whether you evolve and respond to the marketplace or you just die because you're no longer relevant.

TP: I agree. Business strategy or strategic vision is definitely a key element in the succession process. We have witnessed the decline of many businesses, both public and closely held, brought about in many instances by technological advancements.

Is business legacy planning an evolving discipline?

LD: Absolutely. When we started in this business about 25 or 30 years ago, we were at a demographic time in the 1980s when people who'd come back from World War II and started businesses were getting ready to retire. We had the largest transition of businesses in this country ever, and at that point we didn't have a knowledge base about what makes for effective succession. Over the last 25 years we have created that knowledge base.

Our understanding of how these transitions happen is evolving. Now we're at the next generation — many of the people who were doing those transitions then, the baby boomers, are now getting ready to retire. They have a whole different way of thinking about these transitions and succession. They're not thinking about legacy as a purely financial or business matter, but they're thinking more about the opportunities they want to provide for future generations.

TP: Does the dynamic change when a business has been in existence long enough that there are two or three generations?

LD: I think the dialogue changes. When a business is first-generation, there's more of a focus on the person who created it rather than a family or a system. It's less of an institution, and more a matter of "Do I want to follow in dad's footsteps or mom's footsteps?" rather than "Do we want to preserve this legacy?" As you get to a third or fourth generation, you begin to reflect more on what are the elements of the legacy.

There's some research that's been done at Emory University that shows kids who have heard about their family history are emotionally more resilient than those that have not. They can cope with all kinds of life crises because they have a context that provides them a sense of security. They've heard that the family has had its ups and downs — that the family has done really well at times and then has gone through life crises — that it lost assets or was in danger, then came out of that and did better again. Those kids have a context for saying, "We may have good times or we may have bad times, that doesn't mean that we're destroyed." It means that life has cycles and that we can come out of them. So one of the benefits of families sharing a legacy of history and of a transition of family assets is that they have a foundation that can help them understand their opportunities.

Telling these stories is an intangible asset that can be as valuable as the tangible asset of the business. In my own family, my dad never thought in terms of a family business; he was a serial entrepreneur. But when he hit his 60s he started a tradition where he would bring his siblings and their families together with our family at the holidays. Every year we would get together with our cousins and aunts and uncles. And this went on for the rest of his life, and we have continued that tradition in our family so that my children and my cousins' children and soon grandchildren are coming together and getting to know each other — learning from our shared experience, our shared values and how can we provide mutual support.

TP: Are there any special thoughts we need to include if we're talking about non-family businesses that still fall within this closely held category? How does the transfer of values and vision impact a work environment where people's relationships are only professional?

LD: I think for a business founder who is thinking about the transition of his or her legacy when there isn't family involved, the challenge is: "How do I continue to have this sense of relevance if my sense of identity is tied up with my business life?" For many people who have created a business and are considering transitioning out of it and selling it, they really have to think about that — what about that asset, what about that transition can they take pride in and feel good about, and what about it is a loss?

One aspect of that is to give successors the opportunity to practice making strategic decisions about the business before they're gone. Because if you can transition the experience of learning to be a leader to the next generation of leaders, even if they're not in the family, and they have had practice under your tutelage, you are increasing the odds that they will be successful in leading this business that you built without your being there. And that's a gift.

The second thing is to really think about where you take the creative energies and drive that you have and channel it somewhere else. Part of the process of successful transition for an entrepreneur is to think about the fact that that business may not be part of you now, but the energy and the wisdom that created it is still there and can be productive in other ways.

The third element is to be able to say is there a way for you to maintain connections that are important relationships that have been part of your life up to now without staying engaged in the business. Because one of the pieces that happens as one lets go of a business is a fear of isolation. It's good to be able to say, "There's still a role for me in the Chamber of Commerce," or "there's still a role for me in getting together with a group of colleagues in my trade association as a mentor, as an elder. I feel like I'm providing guidance and the use of my leadership abilities."

TP: The first five volumes of our series have gotten very technical at times about subjects that are important to consider, like tax and business entity structures, and finance. But for the final volume, we're talking about emotional, human subjects. How does the hard stuff relate to the soft stuff?

LD: When we talk about legacy we're talking about what we want to transmit. And when we talk about tools like the structure the business and the tax strategies, we're talking about the how. If we go back to the notion of an integrated approach to succession planning, we have to be clear about our vision, where we want to go, and what the quality of that destination is. As individuals, what has importance to us and what has value for us? When you define that, you can structure the succession of assets and succession of other intangible and tangibles to accomplish that.

In summary

Legacy is many things to many people. For one business, the term may connote nothing more than a continuation of sustainable operations. For another, it may extend beyond that into community relevance, reputation, or family involvement. Somewhere in the lifespan of each multigenerational business entity, there is a point at which it becomes more than a mechanism for commerce and employment — it becomes an institution. To people in the know, its name comes to encompass not only a value proposition but also a history, a way of relating to people, and the memory of the people who built it

The emotional task of guiding that change may be the crown jewel of a successful career. Many of our concerns in this series address structure, exit strategy, and succession. When the leadership of a business is the focus, the bolts of succession planning that mechanical level to plan for the emotional context, the pict

is ready to let go, another is ready to take up the mantle, and the business continues as a recognizable brand.

If an effective approach to succession involves a confluence of the technical and the emotional, the barriers to it contain the same paired elements. In practical terms, succession can feel like a distant concern alongside the priorities of everyday work. And in emotional terms, succession can simply be hard to accept.

"Even when everyone agrees that succession planning is important and necessary, reasons to delay the process often sidetrack the discussion," Plaut says. "Running a business takes maximum effort, and long-term planning can take a backseat to short-term issues. And for someone who has poured his or her heart into a life's work, letting go is understandably difficult. Kicking the can down the road on something as important as succession planning is a sure-fire way to invite unwanted surprises into the business."

No matter how a business defines legacy, it has a long list of stakeholders who rely on it — inside and outside the business, inside and outside the founder's family. There are no easy steps in running a business. Doing the work to pass it on intact may be complex, but also offers great potential rewards — for founders and their families, or others who will carry on the business.





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