A DIVISION OF EVERGREEN WEALTH SOLUTIONS

10 PITFALLS TO AVOID WITH SUCCESSION OF A FAMILY RUN BUSINESS

A staggering 87% percent of American businesses are family owned or controlled. These range in size from two-person partnerships to Fortune 500 firms and together they generate 64% of the nation's Gross National Product.[1]

Only about 30% of family-owned business usually survive into the second generation.
12% make it to the third generation and only 3% make it to the fourth generation or beyond.[2]

Why such challenging longevity statistics?
It could be in part the added challenges that come with running a family-owned business or, quite possibly, the many hurdles that can come with succession of that business.

The following are the top 10 pitfalls that owners of family run businesses should avoid when planning their succession.

1. Transferring when the parents are not financially ready.

Being a parent, you want the best for your children. Some business-owner parents who have children that are ready, willing and able to take over their business sometimes put their children's needs above their own and rush into succession. For parents who are not financially stable to transfer a business, this premature move could be devastating to their retirement planning and financial security.

There are also some business owners who may feel financially ready but have retirement plans that require significant funding, which may draw from the business impeding possible growth. Waiting until you, the owner, are financially prepared for a transition is of utmost importance to your retirement and the success of the business.

2. Transferring before the parents are mentally ready.

Waiting to transition until you are financially ready is one thing – but understanding when you are mentally ready is another story. Before a business owner transfers ownership, they need to assess how mentally prepared they are for an exit. Exiting a business that has been built by years of hard work and dedication can be a difficult emotional hurdle. How involved are you in the day-to-day operations of the business? What will you do with your time when you are no longer running the business? These answers will become the key to understanding if you are ready to move forward into the next stage of your life.

3**. Transferring to children who do not know how to run a business**.

It goes without saying that many family members have been involved one way or another in the family business their whole life. But being involved and being in charge are two very different things. Many small business owners forget to realize that the new owners, aka most often their children, must possess or obtain very critical skills and experience to successfully run the business they are taking over. If key skills and responsibilities are missing from the background of a successor, then a part of your succession planning needs to be developed with the goal to train and develop that successor into a better and more qualified person.

4. Not taking advantage of gifting opportunities.

There are a number of lifetime gifting strategies that can be implemented by the business owner to minimize, or possibly eliminate, estate taxes. For parents who plan to transfer the business by lifetime gifts or at their death, gift and estate taxes will apply based on the value of the assets transferred. To transfer the most assets at the least tax cost, it is important to use all of the discounts that are available. Experienced appraisers, attorneys and accountants can help maximize these discounts for tax purposes with minimal impact on the family.

5. Failing to Document the Terms of the Agreement in Writing.

Many business owners assume that when dealing with family members there is no real need for a formal agreement, while others find it a difficult subject to broach, so many times there is no written agreement. The reality is that there is less of a chance of running into future problems if family business owners clearly define the nature of their relationship in writing. In the unfortunate event of litigation, more often than not, the family members will find themselves arguing over the terms of their oral agreements. With as many recollections of "the agreement" as there are family members involved, the opportunity is ripe for more confusion, frustration, and anger.

6. Trying to give everyone an equal share.

While this is a nice idea in theory, dividing your business equally may not be in the best interest of your business.

Management and ownership are separate business succession planning issues.

It may be fairer for the successor(s) you have chosen to run the business to have a larger share of business ownership than family members not active in the business. Or it may be best to transfer both management and ownership to your chosen successor and make other financial arrangements to benefit your other children. Trying to keep everything equal may actually prove to be more unfair in the end.

7. Not adequately preparing the transfer for a potential IRS audit.

For preparing the transfer of ownership, it is important to properly value the amount being transferred for the event of a potential audit. The IRS has a statute of limitations of 3 years to challenge the value gifted. It would be in your best interest to have the business professionally appraised before the transfer to avoid paying more taxes at a future date. If you are audited and cannot document the value of the business at that time, it will be left up to the IRS to determine the market value.

8. Not having your children invest any money into the business.

When you started your business you worked hard to invest your time, money and passion to help it grow. Some family business owners may be tempted to offer an easier road for the next generation – but the truth is that a vested interest is a necessity. Families that simply gift their businesses to their children typically destroy their businesses and their families – usually in that order. On the other hand, founders of family businesses that sell their holdings to family members are typically poised for success.

9. **Not taking the time to protect your business if the unthinkable happens.**

You want to give or sell interests in the family business to family members, but you don't want those interests to stray outside the family if there is a divorce or a death. Granted, we never want to think the unthinkable, such as outliving one of our children, but taking the time to plan for various scenarios is beneficial to both the family and the business should anything happen. Either a trust or a buy-sell agreement can keep the interests in the family regardless of future events.

10. **Failing to review, revise, and update your succession plan.**

Some businesses make the mistake of believing that after a succession plan is written there is no need to revise it. This is a major oversight mistake since succession planning is a dynamic process that is always evolving. One child who fully intended to take over the business may have found a different direction or maybe a child who never expressed interest is now involved. Therefore, succession plans must remain current and should be periodically updated and revised.

<u>Conclusion</u>

Many of these ten (10) pitfalls can be avoided with some forethought and some advanced planning towards your family transfer of your business. Don't fall victim to these pitfalls as all-too-many other businesses will.

Rather, be proactive with your planning and address these issues in an open and honest manner. In the long-run this will benefit all parties involved with the family business.

[1] Van Der Vliet, Daniel. "Measuring the Financial Impact of Family Business on the US Economy", FamilyBusiness.org on June 02 2021, https://familybusiness.org/content/measuring-the-financial-impact-of-family-businesses-on-the-US-ec
[2] "Infographic: The Family Business—Successes and Obstacles", published March 2, 2023. https://www.score.org/resource/infographic/infographic-family-business%E2%80%94successes-and-obstacles
[3] Pepperdine University Graziadio Business Review (GBR), Michael J. Conway, JD, and Stephen J. Baumgartner, MSc(Econ), Volume 10, Issue 2. https://gbr.pepperdine.edu/2010/08/the-family-owned-business/

If you have questions or would like to explore these ideas further, we'd be happy to connect. Reach out to Ed at ed@egwealth.com

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