10 PITFALLS TO AVOID
with Succession of a Family-Run Business

by Summit Financial Group, LLC

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A staggering 90 percent of American businesses are family-owned or -controlled. These businesses range in size from two-person partnerships to Fortune 500 firms. Together they generate roughly half of the nation's gross national product.

Unfortunately, less than one-third of family-owned businesses survive the transition from the first generation of ownership to the second, and only 13 percent of family businesses actually remain in the family more than 60 years.

Why is this longevity so challenging? It could be due to the specific challenges that come with running a family-owned business or, quite possibly, the difficulties that can happen with the succession of a family-owned business. Following are the top 10 pitfalls that owners of family-run businesses should avoid when planning their succession.

1. Transferring When the Business Owner Parents Are Not Financially Ready

Being a parent, you want the best for your children. Some business owner parents who have children who are ready, willing and able to take over their business put their children's needs above their own and rush into succession. For parents who are not financially ready to transfer a business, this premature move could devastate 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. These retirement plans may draw resources away 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 Business Owner Parents Are Mentally Ready

Waiting to transition until you're financially ready is one thing — but understanding when you're *mentally* ready is another story. Before business owners transfer ownership, they need to assess how mentally prepared they are to exit.

Exiting a business that has been built by years, or maybe a lifetime, 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 it? These answers will be the key to understanding whether you're ready to move forward into the next stage of your life.

3. Transferring to Children Who Don't 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 your succession plan must include immediate and practical steps to cultivate that successor into a more qualified leader.

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's 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. Others find it a difficult subject to broach. Consequently, often there's no written agreement of the terms. The reality is that there is less risk 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 confusion, frustration, anger and financial disaster.

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 three 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.

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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 a vested interest is a necessity. Families that simply gift their businesses to their children frequently ruin their businesses and their families — usually in that order. On the other hand, founders of family businesses who sell their holding to family members are typically poised for success.

When children borrow money to invest in a family business, they are assessing their own ability to make money and grow the business.

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 mistake as succession planning is a dynamic process. It 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.

Conclusion

Many of these 10 pitfalls can be avoided with some forethought and some advanced planning toward your family transfer of your business. Don't fall victim to these pitfalls as all too many other business owners will. Rather, be proactive with your planning, and address these issues in an open and honest manner. In the long run, such steps will benefit all parties involved with the family business.