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INSIGHTS

ESTATE PLANNING

The Importance of Estate Equalization in Family Business Succession Planning

THE BIG PICTURE

One of the greatest challenges facing a family business is properly planning for business succession. Business owners may be too busy dealing with everyday business needs to consider the tough issues of succession planning such as: Who will be the next operations manager? Do I want my spouse to own the business when I am gone or do I want him or her to be bought out? Which of the children will get involved in the business? What if my business partner dies? How will I treat my other children?

The list of issues that business owners should consider is lengthy.

However, if the issues are not discussed and a plan is not put into place, circumstances could devolve after the death of the business owner which could spell disaster for the business and the family, even possibly resulting in a forced sale of the business.

Let's look at an example which illustrates the importance of dealing with these issues earlier rather than later. John Smith, age 62, is the sole owner of a plumbing business. His wife Judy, age 61, is a teacher in a local school and is not involved in the business. John and Judy's children are grown and their older son John Jr., age 30, has been working in the family business for 10 years. Their other two children, Jim and Mary, are not involved in the business and have different careers.

John is the main salesperson in the business with all of the business contacts. John also has a long-term employee, Sam, who has become the operations manager, and runs the day-to-day plumbing business. John and Judy's primary means of income is John's salary from the business.

John and Judy face several issues with respect to business succession planning. If they fail to plan, the plumbing business could be thrown into disarray when John dies. John Jr. and the operations manager, Sam, may be able to maintain the day-to-day business activities, but new sales would dry up if John failed to train John Jr. and Sam as the new sales team. If Sam fears the business will fold without John, he may leave to join a competitor. If the business does manage to continue, Judy would be forced to either step in to manage the business as the new owner, or cede management to John Jr. without the expertise to know if he is succeeding in his new role. The failure to address these issues in advance could cause the business to be sold or liquidated.

Turning the business over to John Jr. would also cause problems with Jim and Mary. They may perceive Judy's actions as showing favoritism to John Jr. to the detriment of Jim, Mary and their families. If Judy gives the business to all three children, the day-to-day operation of the company would be complicated and John Jr. might decide to leave and start his own company, further complicating family dynamics and impacting Judy's financial future.

Instead, John and Judy could plan for these issues now, and implement a successful business succession plan. If John believes that John Jr. and Sam would be trustworthy successor owners of the business, he could start training them in both sales and operations. John, Judy, John Jr. and Sam could all agree in writing that if John dies, John Jr. and Sam will purchase the business from Judy. John Jr. and Sam could purchase life insurance on John's life which would provide the cash to pay Judy for the business.

This cash could provide Judy with the security she needs to support herself and the family going forward.

From the family dynamic perspective, since John Jr. paid fair value for his interest in the business, his siblings would not feel slighted. Eventually, Judy could leave her remaining estate to her children in equal shares.

John Jr.'s success or failure would be up to his ability to stabilize the business with Sam and the future of his destiny would be in his own hands. Judy's financial future would not be contingent on her son's success, thus taking substantial pressure off of John Jr. and increasing family harmony.

The decision to purchase life insurance should be based on long-term financial goals and the need for a death benefit. Life insurance is not an appropriate vehicle for short-term savings or short-term investment strategies. While the policy allows for loans, you should know that there may be little to no cash value available for loans in the policy's early years.

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