



A quick look: 10 avoidable missteps that could trip up your business succession

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Business Boosters Guide: 10 avoidable missteps that could trip up your business succession

Are you heading toward trouble without realizing it?

“I’ve learned how to help business owners succeed by working on succession plans with hundreds of businesses, from dental practices to mechanic shops, over my 30+ year career as a financial services professional,” said Paul DeCoursey, with West Point Financial, LLC, a general agency of Massachusetts Mutual Life Insurance Company (MassMutual), “and by being a business owner myself.”

DeCoursey, who also spends much of his time now as a teacher and mentor, offers his expertise to help business owners avoid 10 missteps that often could trip up their businesses and stand in the way of continued, long-term success.

“I have found that the primary, over-arching mistake is a failure to effectively plan for the succession of their businesses,” DeCoursey explained, “whether that means failing to have a succession plan at all or failing to regularly review a succession plan that was put into place at the infancy of a business. All others stem from this.” Here, DeCoursey shares the 10 most avoidable missteps that he’s witnessed time and time again over the years:

1 | Ineffective use of advisors

Most business owners have an accountant or CPA and an attorney, but not many business owners have an accountant and lawyer who are skilled in succession and estate planning or certified for business valuation. In addition to having the right advisors in place, and equally important, those advisors need to work together as a team. The accountant, lawyer and a financial professional should meet as a team and ultimately agree to present one plan that best matches the owner’s own vision of and dreams for retirement.

“I had a client in Chicago who had this very problem,” recounted DeCoursey. “I was able to alleviate the confusing situation by bringing a lawyer to the process who believes in the team approach to planning, understands the value that insurance plays in the succession and estate planning process, and who was a good fit for the sensitivities and personality of the owner.”

2 | No knowledge of how much funding will be needed to maintain lifestyle in retirement

“Not knowing how much income will be needed in retirement to maintain a desired lifestyle is not a mistake only made by business owners,” DeCoursey acknowledged, “but in fact most people do not know how much they will need to retire.”

“The key to this process is helping business owners determine the amount of capital that they believe is needed to support their lifestyle in retirement,” said DeCoursey. Once this foundational amount is established, the next piece of the puzzle for business owners is to determine the value of their businesses and the tax consequences of selling them (see #9 on page 4). If the valuation of their business is actually lower than the owner thinks or the amount of taxes that will be due upon the sale of the business is underestimated, retired business owners may end up with less income than expected and, as a consequence, either have to delay retiring or make a compromise on the lifestyle they had hoped for in retirement. Or, if the shortfall is identified early enough, the owner can insert future royalties into the sales agreement in order to bridge the gap in the retirement lifestyle number.

3 | No consideration for estate planning

The largest aspect of a business owner’s estate is usually the business. In DeCoursey’s experience, business owners often may not establish an estate plan because they fail to understand liquidity issues and the tax implications that their heirs will face.

Estate planning has to take into consideration three questions: what is the plan for the owner’s estate; to whom will the estate pass, and what is the most efficient way to minimize the estate taxes? The biggest issue with estate planning is liquidity. Heirs need to pay estate taxes within nine months of the death. According to DeCoursey, heirs have three options to pay the taxes:

- 1 | Use dollars to pay, which involves liquidating existing assets and may result in paying some capital gains taxes.
- 2 | Leverage existing assets in the estate as collateral for a loan, which the heirs then will be responsible for repaying, with interest.
- 3 | Use the benefits from a permanent life insurance policy, such as whole life. In most scenarios, the business paid premiums to an irrevocable trust, which purchased the policy prior to the insured’s death, to cover the estate taxes, probate expenses, administration fees, and all other demands of the estate.

“When the business owner funds a whole life insurance policy, or any permanent insurance policy, purchased by his or her irrevocable trust, the life insurance proceeds are excluded from the gross estate,” DeCoursey explained.

4 | No provisions in a will for running the business in the owner’s absence

Business owners need to designate in their wills who their successor will be, and most importantly, communicate the designee to all stakeholders: employees, clients/customers, suppliers, bankers – everyone. “Without this step,” cautioned DeCoursey, “the existing employees leave because they are uncomfortable with the resulting successor; customers are worried about the business’ ability to deliver products or services, and so on.”

5 | Selling the business under contract

DeCoursey explained this potential mistake with an example: “A business owner seeks to sell his or her business, finds a

willing buyer and agrees to a selling price – say \$2 million – but when the potential buyer has difficulty with financing, the two establish a contract to pay the owner \$200 thousand per year, plus interest. The owner agrees to the contract and moves to Florida, but the new owner doesn't know the employees or the clients. What if the business fails after two years? The previous owner has lost that income stream.”

DeCoursey offers two solutions to avoid this misstep: “Have your attorney structure the contract, but don't do the whole price; get a chunk of the price upfront. Or stay around for the first few years to be sure the business is successful.”

6 | Leaving family business issues unaddressed

Family businesses have their own set of unique issues: rivalries between siblings or widow and children, birthright versus qualifications to run a company, and sometimes questionable motivations of the heirs.

DeCoursey works with business coaches who look at a business, its legacy, the competency of the children and other factors to help resolve these unique challenges. “I worked with a business in southern Indiana owned by two brothers, both over 65 years old,” he recounted. “One had a daughter and one had a son, and neither could decide who would be the primary decision maker.” DeCoursey set them up with a business coach to resolve the issue. “We cannot put a succession plan together until these questions are answered,” he explained.

7 | Waiting too long to find a buyer for the business

Within three to five years of retirement, business owners should start to find a successor to buy the business. “Of course, this plan demands that the owner sets an expected retirement date and sticks to it,” warned DeCoursey. “Many business owners say, ‘I never want to retire,’” he continued, “but they really just don't know how to do it without compromising their life style.”

By waiting too long, owners may be experiencing poor health and low energy, which could affect productivity and potentially the profitability of their company. “As a result, they may receive lower offers for the company and take a haircut on the return of, from what I've seen, up to 25 percent,” concluded DeCoursey.

DeCoursey offers three options to establish a successor/buyer early:

- 1 | Family members: Are there children or other blood relations who are capable and want to run the company?
- 2 | Existing employees: Are there employees who are capable and want to run the company? This solution may not compromise the profitability of the company.
- 3 | Outside buyer: Being able to take the necessary time to find a suitable buyer while the company is at its peak could ensure continuity and a maximum selling price.

8 | No provisions in buy-sell agreement to address long-term disability or divorce

Most buy-sell agreements provide for the death of one of the owners of a business, but many business owners overlook adding in provisions against the long-term disability or divorce of an owner. “In the case of death, the agreement obligates the owners to sell the share so that the widow doesn't end up running the business,” explained DeCoursey.

In the case of disability, a trigger could be built in to force the sale of the share after a partner has been disabled for two years and does not return to the business. “Divorce ought to be included in the buy-sell agreement, as well,” said DeCoursey, “so the remaining partners don't end up inheriting the ex-wife or ex-husband who doesn't know anything about the business.” He told of a small business client with three owners who did not provide for divorce in the buy-sell agreement. “When one went through a divorce, it could have been disastrous to the client, if the courts had awarded the ex-spouse a share of the business.”

9 | Lack of awareness of tax consequences from sale of C-corporation business

“Owners of C-corporations need to be aware that, effectively, they pay taxes twice,” DeCoursey explained, “capital gains taxes on the sale of the company stock and corporate taxes on corporate earnings up to that point – a double haircut.”

However, if a business is an S-corporation, the owner who sells will only be taxed at the individual rate. Changing a business from a C- to an S-corporation could alleviate the tax burden from the sale of a business, but owners need to make this change at least 10-years prior to the sale, or the taxation will revert back to a C-corporation.

In either case, business owners need to be aware of the amount of taxes that will be owed on the sale of their business and plan for their retirement income accordingly. An owner who determines that he or she will need \$2 million dollars to retire and is confident that sale of the business will result in the \$2 million, will end up falling short, after taxes.

10 | Insufficient funding to protect the owner and business

Business owners must have sufficient funding to protect their business against the loss of a partner or key employee. The key issue here is *liquidity*. Funds must be readily available to buy the stake of a deceased partner or to train and replace a key employee. DeCoursey maintains that one of the best sources for liquidity is whole life insurance. “Very recently I met with client business owners, a husband and wife team,” he said. “We determined that \$10 million dollars needed to be available in liquid assets to maintain and protect the business. How much did they have in place? The wife had \$10,000 and the husband had \$25,000. They were at risk for the balance.”

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