

Succession Planning for Small Businesses

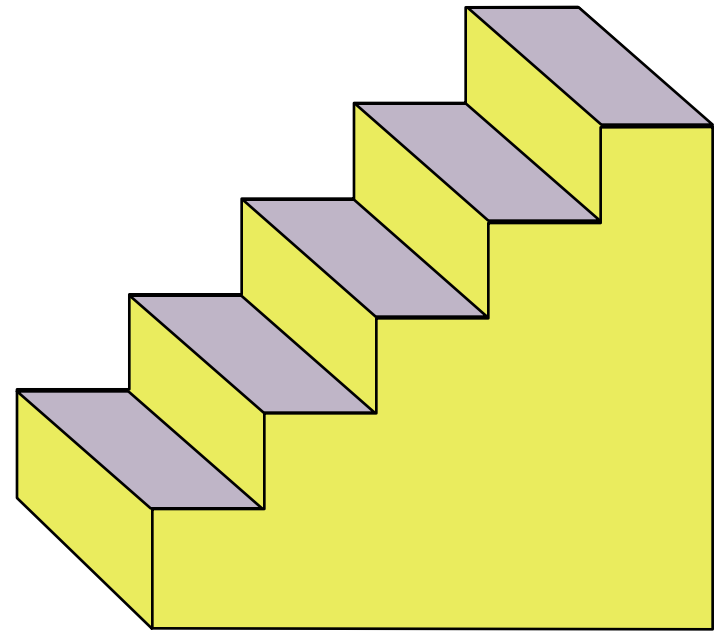
Notice

This presentation is designed to provide introductory information regarding the subject matter covered. Neither ING nor its representatives offer legal or tax advice. You should always consult your attorney and tax advisor regarding the applicability of this information to your individual circumstances.

Four Steps to Successful Business Succession Planning



- ◆ **Understanding the Need**
- ◆ **Selecting the Plan Type**
- ◆ **Valuing the Business**
- ◆ **Financing the Arrangement**



What's your "Dream" ?



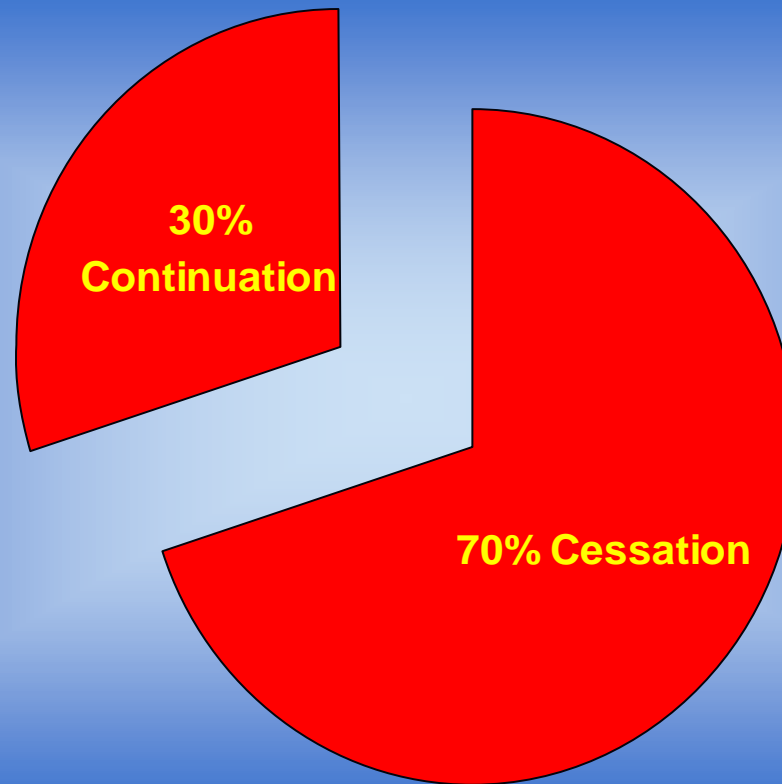
- ◆ **79% of small business owners say that they want to retain their business within the family**
- ◆ **70% of second generation family members share the hope of retaining the business within the family ***

• Arthur Anderson, American Family Business Survey, 1997

What's the "Reality" ?



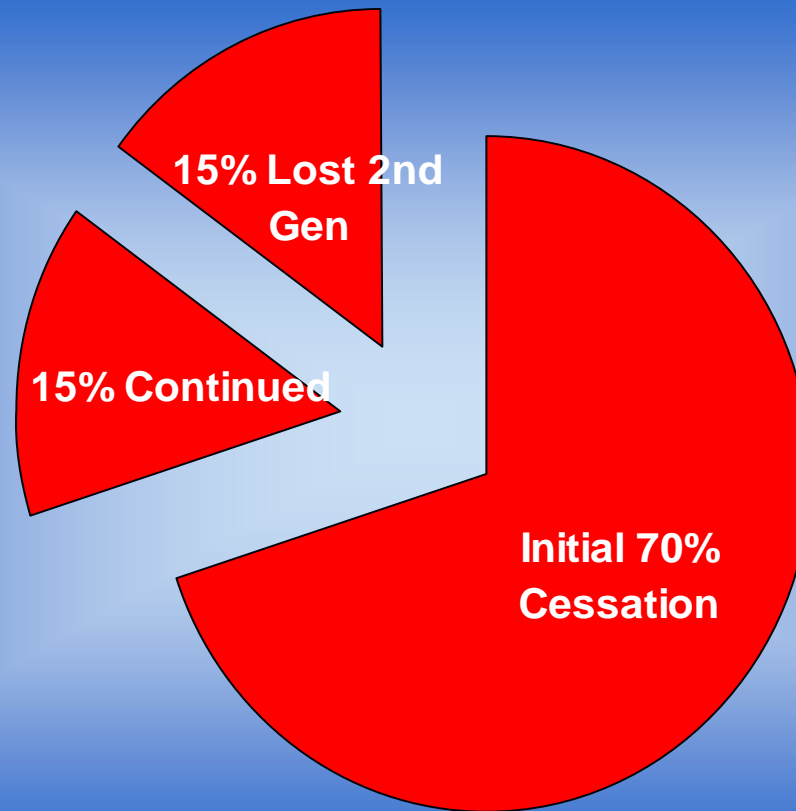
Cessation rates from 1st into 2nd Generation*



What's the "Reality" ?



Cessation rates from 2nd into 3rd Generation*



Issues that affect Family Business Transitions



- ◆ **Lack of a clear, well-defined succession plan**
 - ✓ **May create conflict between family unity and the continued success of the business**
- ◆ **Failure to address the issue of who will run the business**
- ◆ **Failure to ensure that surviving spouse will have market for their ownership interest and sufficient lifetime income**

Proper Planning Can . . .



- ✓ **Ensure the future succession of the business**
- ✓ **Avoid conflicts between the remaining owners and the heirs**

What events do we need to plan for?

There are several occurrences or events that can disrupt a business –

- ✓ **Death of an owner**
- ✓ **Disability of an owner**
- ✓ **Bankruptcy or divorce of an owner**
- ✓ **Retirement of an owner**
- ✓ **Withdrawal prior to retirement**

What is a succession Plan?



First – The “human” issues

Second – The agreement itself:

- Select type of succession plan
- Figure out how much the business is worth and how it will be valued in the future
- Figure out how to pay for the plan

Some of the “Human” Issues



- ✓ Who are the “key” players?
- ✓ Has ownership been promised to anyone other than the current owners?
- ✓ Which family members are currently active in the business?
- ✓ What is their commitment to the business?
- ✓ Has a promise been made about who will succeed to control?
- ✓ Are there family members not involved in the business that want in?

Other Important Questions



- ✓ Is there a long term business plan?
- ✓ Why is the business profitable?
- ✓ What are its weaknesses?
- ✓ What is the profitability of the business if you aren't here to lead it?
- ✓ How will the business' creditors react if you die or become disabled?
- ✓ Would you consider selling the business to key employees?
- ✓ Are there any key employees who can afford to buy it?
- ✓ How important is it to you to guarantee that your business will be controlled by the parties that you select?

When a business owner dies or becomes permanently disabled, the business itself may die or be permanently disabled on the same day –

not because something wrong was done – but because nothing was done!

Select Type of Agreement



There are three basic types:

- ◆ **Cross Purchase**
- ◆ **Redemption**
- ◆ **Wait & See**

Cross Purchase



An agreement among business owners to collectively purchase the interest of a departing owner at a specified or ascertainable price.

An agreement that the business itself will purchase a departing owner's business interest at a specified or ascertainable price.

Wait & See Arrangements



An agreement that permits the business owners to wait until the first death or other triggering event occurs to decide whether the business or the owners will purchase the business interest.

The Importance of Business Valuation



- ◆ **Valuation is the process of arriving at what the IRS calls “fair market value.”**
- ◆ **Helps minimize conflicts between shareholders and with the IRS**
- ◆ **Can establish value for estate tax purposes**

How to Value the Business?

Some possible approaches:

- ◆ Agreed upon fixed price
- ◆ Book Value
- ◆ Earnings based valuation
- ◆ Appraisal

Is the Value Acceptable to the IRS?



It is important that the value be acceptable to the IRS so that

Selling price = Estate Value

Factors to consider:

- ✓ **Obligation to sell**
- ✓ **Restriction on lifetime transfers**
- ✓ **Determinable & reasonable price**
- ✓ **Bona-fide business purpose**
- ✓ **Arm's length transaction**

How is it Financed?



- ◆ **Borrowing**
- ◆ **Establishing a sinking fund**
- ◆ **Installment payments**
- ◆ **Life Insurance**

◆ Borrowing

- Can substantially increase costs
- Credit and financial strain on business
- Not guaranteed

◆ Sinking Fund

- Simple
- Set-aside capital each year
- Uses after-tax dollars
- Potential Accumulated Earnings Tax
- Subject to corporate creditors
- Not guaranteed

- ◆ **Installments From Business Cash Flow**
 - **Depends on uncertain future profits**
 - **Financial strain on business**
 - **Limited liquidity for decedent's estate**
 - **Not guaranteed**

Financing the Plan



◆ Life Insurance

- Provides the potential for policy cash values when needed*
- Death proceeds are typically received free of federal income taxes
- No financial strain on the buyer at the time of the purchase
- Cash value accumulations can be used as a substantial down payment in the event of other triggering events (disability or retirement)
- Wide variety of life insurance products available

•Income tax free cash distributions are achieved by withdrawing to cost basis (premiums paid) then using policy loans. Withdrawals will reduce the policy's cash value and may reduce the policy's death benefit.

Benefits of Succession Planning



- ◆ **Creates a guaranteed “market” for the business interest**
- ◆ **Allows those who are interested in continuing the business to do so without interference from the deceased owner’s heirs**
- ◆ **Assures that the decedent’s heirs receive a reasonable price for the business interest**
- ◆ **Provides liquidity for the estate of the deceased owner by turning the business interest into cash**
- ◆ **Establishes the value of the business for death tax purposes**

**Do you have a succession plan
for your business?**



Thank you.

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