HB Wealth

Contingency Planning For Business Owners

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Successfully transitioning a family business requires time and energy above and beyond what is already required to run a business. A successful family business transition should ensure that both the business and the family prosper, and to achieve a successful transition, a business owner must have a transition plan in place. In fact, a business owner generally needs two plans: a long-term strategic plan and a contingency plan. A strategic plan may involve planning for family succession or for the sale of the business and seeks to maximize the value of the business, taking into account the owner's liquidity needs and the family's legacy goals.

A contingency plan is typically incorporated into a business owner's overall estate plan to minimize potential issues that may result if the business owner dies or becomes incapacitated before the strategic transition plan can be fully implemented. Most of us don't want to think about contingency planning because it is planning for something that we hope doesn't happen, but having a contingency plan in place can be critical for preserving the value of the business and maintaining family harmony when the unexpected happens. Below are some considerations for family business owners regarding putting a contingency plan in place.

Determine Control of the Business

For contingency planning, it is often best to leave a family business in trust. A trust is a relationship in which one person holds title to property, subject to an obligation to keep or use the property for the benefit of another person. This allows a business owner to separate the legal ownership and control of the business from the beneficial enjoyment of the income and proceeds from the business. In addition, because a trust holding an operating business can be more challenging to administer than a trust holding liquid securities, it is common to have a separate "business trust" just for the business with trustees that can provide appropriate oversight.

Leaving the business in trust can provide stability for the family and employees. If the owner's children are not involved in or lack the skill to run the business, then having the business in trust allows the owner to appoint trustees with an understanding of the business. This may be a key employee or a trusted advisor such as the company's attorney or CPA. If one or more of the owner's children are involved in the business, then having the business in trust allows the owner to appoint one or more independent trustees to help resolve any family disputes that may arise regarding the business. A "board of trustees" may include the children along with key employees and trusted advisors.

Decide How to Divide the Business

A closely held business often makes up a large portion of the owner's total net worth, but the business owner may want to leave the business only to certain children based on their involvement in the business. It is not necessary that one's estate be divided equally among their children, and "equal" isn't always "fair." If one child has taken charge of the business and grown it significantly, then that child may deserve a larger share of the business than the other children who have not contributed. However, a business owner can structure the business so that the children receive equal shares while ensuring that the child who was heavily involved has control over the business.

Similar to how a trust can be used to separate ownership from beneficial interest, a business can be structured so that only a small percentage of the ownership has voting rights. Restructuring the business to have voting and non-voting ownership interests allows the business owner to leave the business equally to the children, but give the voting interest only to the child involved in the business. If the business owner decides to leave the business in trust, then it may not be necessary to have voting and non-voting ownership interests, but being able to structure the business this way is another option to preserve the value of the business and maintain family harmony.

Assess Liquidity Needs

A valuation is critical for business transition planning. A valuation expert can help a business owner understand not only what the business is worth, but also what options are available for transitioning the business. Some businesses are very marketable, and the most benefit for the family may come from an immediate sale. Other businesses may have strong cash flow but no apparent buyer, in which case keeping the business and fostering family participation may be the best option.

A valuation is also important in identifying estate tax and liquidity issues. Individuals are allowed to give away a certain amount of assets during life or at death without those assets being subject to the federal estate and gift tax. The lifetime exemption in 2023 is approximately $12.9M ($25.8M for a couple) but is scheduled to essentially be cut in half at the end of 2025 under current law. If a business is likely to be held rather than immediately sold, then the estate may need liquidity to pay estate tax.

Life insurance can be an easy and effective way to provide liquidity, but it is not always an option due to cost and insurability. A loan is another option for liquidity, but this again may not be a good option depending on the credit environment and the business's cash flow needs. There may not be an easy solution to a liquidity issue, but addressing the issue as part of a contingency plan can help to minimize any potential problems.

Implement the Contingency Plan

Once a business owner has determined who should control the business and how the beneficial interest in the business should be divided and held, having an attorney draft the necessary documents is a straightforward process. However, finalizing a contingency plan is emotionally challenging. A business owner is signing off on a plan that they hope will never be implemented. It is important to acknowledge that a contingency plan is not what anyone wants, but it is the best plan to preserve the value of the business and maintain family harmony based on current information. If there is ever a time when perfection should not stand in the way of progress, it is contingency planning.

If you have any questions or would like to discuss your contingency plans further, please reach out to your client service team, visit us at hbwealth.com, or call 404.264.1400.

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