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A STRATEGY SPOTLIGHT

The Importance of Estate Equalization in Family Business Succession Planning

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. This 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 that illustrates the importance of dealing with these issues earlier rather than later. Jack 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. Jack and Judy's children are grown, and their older son John, 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.

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

Jack 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 Jack dies. John and the operations manager, Sam, may be able to maintain the day-to-day business activities, but new sales would dry up if Jack failed to train John and Sam as the new sales team. If Sam fears the business will fold without Jack, 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 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 would also cause problems with Jim and Mary. They may perceive Judy's actions as showing favoritism to John 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 might decide to leave and start his own company, further complicating family dynamics and impacting Judy's financial future.

Instead, Jack and Judy could plan for these issues now by implementing a successful business succession plan. If Jack believes that John would be a trustworthy successor owner of the business, he could start training him in both sales and operations. Jack, Judy, and John could all agree in writing that if Jack dies, John will purchase the business from Judy. He could purchase life insurance on Jack's life that would provide the cash to pay Judy for the business. This cash could provide her with the security she needs to support herself and the family going forward.

From the family dynamic perspective, since John paid fair market 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.

Sam, as a key employee, is critical to the success of the business. Jack and John may want to also consider a nonqualified plan that would help retain Sam.

Under this plan, John's success or failure would be up to his ability to stabilize the business. 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 and increasing family harmony.

For more information, contact a MassMutual Financial Professional.

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AS8009 1019 CRN202110-255170