

Succession planning

A practical guide for owner-managed businesses



Make a smart move

Shares held by an individual, which either on their own or with others acting together, control a private company, will have to be sold or transferred at some stage in the future – either on the death of the owner or as a result of a decision to sell by the owner.

This guide identifies the key issues that need to be considered to prepare a succession plan which balances your needs with those of your family, shareholders and the business.

Why prepare a succession plan?

The preparation of a succession plan forces you as the owner of a major stake in a private company to consider matters in respect of:

- **yourself** – your future income needs, how long you want to remain active in your business, who has the management skills to run your business in the future, etc;
- **your family** – their future income, their involvement in the business, fairness and equity between your children;
- **other shareholders** – how will your actions/plans affect the other shareholders; do their requirements need to be considered?
- **your business** – how will your departure affect your business; will the key employees feel insecure, will the business lose value with your departure?

Succession planning covers two basic matters – ownership and management. They are strongly interlinked but do need separate consideration.

Objectives of the succession plan

Your succession plan will be greatly affected by your own personal circumstances – age, health and personal plans.

Its objectives will be based on what is best for you, your family and any others you would wish to be involved in the succession, either regarding management or ownership of the business.

The objectives may include one of the following:

- your own family continuing to own and manage the business;
- continuing family ownership with outside management;
- selling the business to key executives or employees;
- selling the business to competitors or other outsiders;
- reorganising the business to sell part and retain part;
- winding up and liquidating the business.

Issues to be addressed in the succession plan

Management

- will the transfer of management or ownership damage the business as a result of:
 - reduction in value of the business;
 - insecurity amongst employees;
 - loss of confidence by suppliers;
 - creditors/customers;
- do any family members who will have responsibility for the management of the business have the necessary talents, desires and skills to keep the business running successfully over the long term?

It is rarely advisable to provide all children, or relatives, whether active in the business or not, with an equal standing in the business after you leave it. The interests of those in the business usually conflict with those who are not.

Ownership

- For practical or commercial reasons you may choose to dispose of your shares in the business and make a gift of the disposal proceeds. The implementation of appropriate tax planning may be available to mitigate tax arising on the disposal of the shares and any subsequent inheritance tax on the gift of the proceeds – whether that is a lifetime gift or a gift on death;
- conflicts can arise between shareholders and management of a business where the two are not identical. In these circumstances it is advisable to create a shareholder agreement which defines how management and shareholders should be rewarded;
- where family members are involved in the succession, it is usually advisable to discuss the issues frankly with them. Family members may make incorrect assumptions which can lead to disappointment and the breakup of family-owned businesses. It is usually advisable for the succession plan to be in writing, family and close associates to be aware of its contents and know where the plan is kept;

- although your succession plan will be driven by a variety of factors, including your personal circumstances and any practical or commercial considerations, it is crucial to seek advice on the tax implications arising as a result of any proposed planning.

Structuring and financing a succession

The final step in a business succession comes when ownership is actually transferred to your successors. When this happens your concerns will focus on:

- assigning a value to your business;
- structuring a sale/transfer;
- determining adequate financing;
- obtaining security if the proceeds are payable over time; and
- mitigating tax.

How much is your business worth?

Valuing a business is not a precise science, it is subjective and requires the application of experience and judgement. Whatever methods are adopted in valuing a business, ultimately the valuation is that which a willing purchaser is prepared to pay a willing vendor. The most critical issue, therefore, is understanding the balance between the price the vendor wishes to achieve on giving up ownership of the business and the price the purchaser puts on the opportunity to exploit the business.

A succession strategy will endeavour to establish a business valuation which meets this by considering the following factors:

- financial history and forecasts of your business;
- industry and market;
- management organisation and skills.

Structuring a sale

The strategy employed when structuring the sale of your business will take into account your personal circumstances and to whom the business is being transferred; whether that is a family member, co-owner, employee or third party. A key factor that must be considered at this stage is the tax implications arising from the proposed structure.

“Whatever methods are adopted in valuing a business, ultimately the valuation is that which a willing purchaser is prepared to pay a willing vendor.”

Although the finance of the purchase is usually the buyer's concern, there may be times when you need to help the buyer (for example, when selling to family member, co-owners or employees) obtain the finance. Finance could include mortgages, sale and leaseback arrangements or long term buy-back arrangements. Alternatively you may decide to reduce the value of the business before sale by paying a dividend or by a share buy-back. Finance arrangements such as these can be complicated and will require both legal and tax advice.

Securing security on a sale

When sales proceeds are not immediately receivable you will need to take adequate protection in case the purchaser cannot pay the full purchase price. Generally, it is harder to obtain security on a sale of shares than it is on the sale of assets. Some methods that you can use to improve the security of your debt could include:

- obtaining life assurance on the buyer's life;
- having the shares as security for the proceeds so that you regain control of the company if you don't receive full payment;
- taking a specific charge on the assets of the company as security.

Gifts of shares

When considering gifting shares to family members or possibly the existing management, there are many practical and commercial issues to consider – not least, of which are the tax consequences arising from the gift. In reality, most gifts of shares will give rise to some tax implications, regardless of whether it is an outright gift or one into trust; or a gift to the existing management. Timing is also a consideration. Therefore if it is a gift in the future, it is important to ensure that a will is drafted to reflect your wishes.

Estate planning

The succession plan for your business performs part of your estate planning which includes all of your assets, including your business asset. It describes how and when you will pass on your assets to your successors.

The transfer of management and ownership of a business can be a disruptive time for both family and business associates regardless of whether it occurs upon your death or during your lifetime. Timely estate planning helps minimise these disruptions and the taxes payable on the transfer of your assets.

Wills

Everyone with assets to transfer on death should have a Will designating who will receive them. When an estate holds business assets a Will is even more important. If you die without one, the intestacy laws will automatically apply to dictate how your assets will be distributed to your next of kin. That distribution will probably not reflect your preferences and may jeopardise your business.

Wills are also essential to minimise taxes that may be triggered at death.

“The succession plan for your business performs part of your estate planning which includes all of your assets, including your business asset. It describes how and when you will pass on your assets to your successors.”

Your Will should be reviewed every few years and whenever there are changes in personal, financial, family or other beneficiaries' circumstances. Changes in tax and other relevant legislation will also affect your Will. Due to its potential complexity, you should consult your legal and business advisers when preparing a Will. Some major issues to discuss are:

- **legacies** – do you want to leave gifts of cash to any beneficiary?
- **specific bequests** – do you wish to leave any specific property to a beneficiary? Business owners should make special provisions for disposing of their interests in the business;
- **residue** – the residue of your estate is all the property and assets left after debts and legacies are paid and specific gifts carried out. How will you dispose of the residue? If a share is left to children, will they receive it upon your death or later, such as when they reach a certain age?
- **executor** – your choice of executor is important, especially if administering your estate will take time to complete. Generally it is advisable to ensure that the person you propose naming as your executor is able to act as such;
- **trusts** – these can be useful in estate planning. They can be set up through your Will or during your lifetime. Trusts must comply with various specific legal requirements so its important to obtain professional assistance when setting one up. A trust can give parents greater control over shares in their capacity as trustees. Trusts can also provide flexibility with shares to be distributed among children.

Lifetime gifts

Lifetime gifts are likely to be an important feature of estate planning; it is important to integrate plans for the transfer of shares during the owners lifetime, with his income and capital needs during his life and the planned value of his estate on death which will be dealt with in his will.

Taxation

Succession planning is an emotive subject and will be based on your personal circumstances and objectives. Consequently there are no general rules to determine the best strategy to put in place. However, whichever strategy you choose to implement it is important to consider the tax implications arising from that strategy.

Minimising tax on a sale

The tax effect of the sale structure and method of financing will significantly affect the total profit on the sale of your business. For that reason the tax advantages gained, either by you or the buyer, will influence the final purchase price.

We can evaluate whether it is more advantageous for you sell your shares in the company or sell the business assets.

Taxes payable on lifetime gifts

As mentioned before, a gift of shares will give rise to tax implications. However for capital gains tax and inheritance tax purposes, the taxation of shares in private companies has probably never been more favourable as both capital gains tax and inheritance tax encourage the gift of private company shares (including those listed on the Alternative Investment Market)

Capital gains tax

A gift of shares is a disposal at market value and is generally taxed in your hands. However, subject to certain conditions being fulfilled, any gain arising on the gift of the shares can be 'held over'. This means that the person who receives the shares will effectively be responsible for the tax on the gain when they ultimately dispose of the shares.

Inheritance tax

Certain lifetime gifts can be made without incurring an inheritance tax liability, provided that the person who makes the gift survives for seven years from the date of the gift. Subject to the seven year condition, potentially exempt transfers allow you to make unlimited gifts with no charge to inheritance tax.

In addition, where certain conditions are met, business property relief (BPR) is available to eliminate an inheritance tax liability arising on the gift of private company shares. BPR applies both to gifts of shares within seven years of death and the transfer of shares on death.

“The capital taxation of owners shares in private companies has probably never been more favourable.”

Taxes payable on death

Inheritance tax

Inheritance tax is chargeable on certain lifetime transfers (for example, gifts made within the last seven years) and on the value of your estate on death. However, various exemptions and reliefs (including business property relief) are available to reduce the amount of tax payable.

In addition, by careful planning during your lifetime there are many practical ways of reducing inheritance tax. For instance, lifetime gifts which are potentially exempt transfers allow you to make unlimited gifts without incurring any inheritance tax liability, provided you survive seven years from the date of the gift.

We can provide details of all the relevant exemptions, reliefs and planning opportunities available to mitigate inheritance tax.

Capital gains tax

Capital gains tax is not charged on the transfer of assets on death. The beneficiary will be treated as receiving the assets at open market value.

However, any capital gains arising prior to death are taxed in the deceased's final tax return.

Income tax

Income earned up to the date of death is taxed in the deceased's final tax return. Income earned after the date of death is usually included in the estate's income and is therefore taxable on the estate or on the beneficiaries.



How can Deloitte help?

Our approach is to offer assistance at every stage of the business improvement process. This ensures you can access expert help when you need it but also ensures that you don't spend money paying for services that you can perform yourself.

Subject to ensuring safeguards are in place to maintain our independence where we also act as auditors to your business, our advisers can assist you with every aspect of succession planning.

Identifying the issue

- Assisting you with the early identification of the likely succession issues to ensure timely action.
- Helping you to review your current situation and assist you in formulating your own objectives for the future.
- Helping you to identify the other individuals and groups that you will need to consider when formulating your succession plan.

Quantifying the impact to your business

- Advising you of the specific tax implications to be considered in connection with all aspects of your succession plan.
- Assisting you to quantify your future financial requirements to realise your aspirations outside the business including funding of future pensions and servicing other personal financial obligations.
- Helping you to balance the demands of owners, who wish to extract funds from the business, and the business itself and the need to retain funds to support future growth and profitability.
- Using our experience of similar situations to help anticipate some of the indirect consequences of business succession, including maintaining customer and supplier relationships and motivation of employees and management.
- Working with you to develop a succession plan that meets your needs and those of your business whilst maintaining tax efficiency.

- Helping you to mitigate your taxes after selling your business and planning for your future.
- Working with the buyers of your business, or your successors to ensure your tax position is maximised on a sale or transfer.

Developing recommendations

- Acting as a sounding board for your ideas for the business after your exit and helping you consider the widest possible range of strategies to achieve your goals.
- Helping you to structure your ideas into a form appropriate for ongoing use in the business and capable of securing buy-in from other interested parties.
- Credibility checking your proposed action plans for wider business issues, including the potential taxation implications for yourself, the other stakeholders and the business.

Helping you to implement a strategy

- Acting as mediator between those parties with differing long term objectives and aspirations including, for example, family members with fragmented shareholdings.
- Providing project management assistance to ensure efficient development and execution of your plan.
- Assisting you to secure and maintain stakeholder and employee buy-in to your proposed succession plan.

Reviewing the effects of the strategy

- Assisting you to evaluate the personal and business impact of your succession plan as it progresses.
- Helping you address any unanticipated areas of financial or management weakness arising from the completion of the plan.
- Helping to revise and update your strategies as the business environment and your own objectives change.
- Completing independent reviews of the effectiveness of any new management procedures that have been implemented as part of the plan.

Monitoring the future health of the business

- Providing business advice as and when required by the new management to help bridge the succession gap.
- Helping you stay alert to business issues which may impact on the completion of the strategy or any residual financial interests you may have in the business.

For further information, visit our website at www.deloitte.co.uk

In this publication references to Deloitte are references to Deloitte & Touche LLP. Deloitte & Touche LLP is a member firm of Deloitte Touche Tohmatsu.

Deloitte Touche Tohmatsu is a Swiss Verein (association), and, as such, neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each member firm is a separate and independent legal entity operating under the names "Deloitte", "Deloitte Touche Tohmatsu", or other, related names. The services described herein are provided by the member firms and not by the Deloitte Touche Tohmatsu Verein.

Deloitte & Touche LLP is authorised and regulated by the Financial Services Authority.

This publication has been written in general terms and therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication.

Deloitte & Touche LLP would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. Deloitte & Touche LLP accepts no duty of care or liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

© Deloitte & Touche LLP 2004. All rights reserved.

Deloitte & Touche LLP is a limited liability partnership registered in England and Wales with registered number OC303675. A list of members' names is available for inspection at Stonecutter Court, 1 Stonecutter Street, London EC4A 4TR, United Kingdom, the firm's principal place of business and registered office.
Tel: +44 (0) 20 7936 3000. Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London.

Member of
Deloitte Touche Tohmatsu