SUCCESSION:
Without It — Failure

Success, Without Succession, Is Failure—And Contractors Should Plan NOW For Their Companies’ Continuity

By Arthur Jamison

It has been said, time after time, that success, without succession, is failure.

Yet in the construction industry, marked by many companies that rose to great achievements largely on the talent and drive of the originator, success has died with the originator.

Many contractors know of outstanding companies that went this route and these same contractors often speculate about their own future and the future of their companies. Unfortunately, this speculation is enjoyable in too many cases just so long as the speculation makes no effort to try and look too far ahead.

It can be difficult and distasteful to visualize a world after our own lifetime. When contractors and other businessmen think about estate planning, will provisions, life insurance, and the other long-term future considerations of their families and of their businesses the thinking does tend to be somewhat unpleasant and often shallow.

Often as not, it is done once, forgotten. Furthermore, it is often delegated to an attorney, trust officer, or insurance agent.

Consequently, many construction firms are not adequately safeguarded against the future. This leaves the inevitable question of who will run and control the business as well as how to protect it against the ravages of the IRS.

As an example, there are quite heavy estate taxes to be paid within six months of your death and therefore the need for substantial cash arises at that time.

Of course, most businesses do carry life insurance for this purpose but there is always the question of whether or not it is adequate. When a man is relatively young he customarily purchases insurance for the time when he will be old and needs it.

His good fortune may have carried his estate far beyond the protection afforded by his insurance coverage.

More Taxes

Additionally, there is another round with estate taxes when the wife passes and the tax bite is substantially greater. And seldom does a contractor or businessman purchase enough insurance on his wife to protect his sons and daughters from this second and often disastrous trip to probate.

For the most part, contractor/owners tend to leave the ownership (common stock) of their businesses to the wives along with other investments, and the widow wins up owning control of a business about which she knows little in the way of day-to-day operation, along with title to investments she also knows little or nothing about managing.

The son, if there is one, is told he will own the company “someday” but he isn’t told that he will get what is left after two heavy estate taxations and after a wait lasting for many years.

Meanwhile the founder’s widow owns and controls the business but the son—or appointed heir—is expected to run it. Because the founder simply neglected to do some serious planning, with the son’s welfare and inheritance in mind the latter’s chance of ever having that business to run can be eliminated.

The equity that survives taxes (and debts to pay taxes) may not be sufficient to survive the years when a relatively untrained person owns it and a powerless one tries to manage it.

Here is how it worked in a couple of classic cases:

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No. 1 Case History

The owner of a successful dry-wall contracting business died in 1966, leaving an estate consisting of his home, the business, $50,000 in insurance, and cash amounting to $12,000. The company had a backlog of only $125,000 at the time of his death. Estate taxes and probate expenses totalled some $70,000.

He left the company to his wife, who had never worked in it and knew little about it. Two sons were involved, both competent journeymen. They were strong competitors and, urged on by their wives, had become heated rivals for the nod as successor.

The contractor, though, never got around to making up his mind, and passed along this situation to his widow. Subjected to conflicting advice and pressures from her attorney, the company accountant, banker, and her at-war sons, she compromised by making them co-managers. The new financial system cut the firm into halves.

In order to settle the estate taxes, she borrowed money, then increased her own draw by enough to cover the payments, and gave both sons raises as compensation for their increased responsibilities.

By the time she’d finished, profits were zero. At best, the firm could barely survive; at worst, it was a continual infighting exhibition between the two sons. When the widow died in 1972, she left insurance of $25,000, taxes and probate costs of more than $100,000. She also left the firm equally to the two sons.

They, in turn, sold her house and other possessions to settle the estate and were short by over $20,000. One son wanted to borrow it and the other wanted to sell the firm and start over.

By the time they’d finally paid off the estate taxes they had become bitter enemies. Unable to work together, the one brother sold his half to the other who had to mortgage his inheritance so deeply that it may never be worth the owning. The result of all this is two brothers made into enemies and a business down the drain.

Comment: The above case is given in detail because it is typical of the many ways a contractor/owner can go wrong. This contractor had inadequate insurance to begin with, and he left control of a firm to his widow who not only knew little about the business but could not successfully referee the two sons which was another unfinished bit of work.

The father should have made his selection, announced it to both sons, and then left all his common (voting) stock to his successor. Had he also created a new class of stock, such as preferred or nonvoting common, a rightful share could have been left to the widow and other heirs. This would have left control with the one person who had to run the business and make the decisions.

No. 2 Case History

The owner of a highly diversified wall and ceiling firm, the owner/originator had no sons but two married daughters and a very young second wife. He had a deal to sell the firm upon his death to one of his superintendents, who purchased an insurance policy on the owner’s life to provide the agreed $350,000 price.

In his will, the owner left half the value of the firm to his wife and the balance to his daughters. But then the IRS decided the firm was worth $660,000.

This had no effect on the estate taxes, which were fixed by the buy-sell agreement, but the probate court, using the IRS valuation, handed the widow $330,000 of the income from the sale of the business, leaving the daughters only $10,000 each.

They hired lawyers to fight the court decision, since their father’s wish was apparent. Only the lawyers won this one.

Comment: Remember that when the time comes to settle the estate
the IRS will decide the value of the assets. The basic dishonesty of such an arrangement may be readily seen, but forget about ideas of your widow or youngsters being able to fight it out.

When it comes to valuing a business, the IRS—which usually knows not all that much about evaluating a construction firm—has a field day and can, often as not, pick a number out of thin air, defying your survivors and try and prove them wrong. Only the lawyers win these kinds of battles.

The truth of the matter is, the only way to prove the value of the firm is to sell it before the question comes up. The IRS cannot deny the price you get (unless you sell it to a relative), but they can totally ignore the price the business brings a week after their making an appraisal.

When you decide upon your insurance coverage, do plan for the worst. And if an arrangement is made to sell the firm upon your death, make the price contingent upon the actual value of the firm at the time. In writing your will, watch out for language that doesn’t say what you want it to say.

Summary: Your estate and succession arrangements should be reviewed every few years. Estate taxation laws are constantly changing, rates keep moving upward, and inflation gobbles up the purchasing power of arrangements made even a few years before.

Make certain that your insurance will cover your own estate’s cash needs and that there is enough for your wife’s estate where the taxes are much heavier. Select and train a successor and then make specific plans for leaving control to him.

You could do this by selling much of your own common voting stock back to the firm, and creating a new class of nonvoting stock to leave your widow and other heirs as a fair inheritance.

And, most importantly, get your banker, lawyer, and accountant together with your insurance man soon—and reexamine the subject every three to five years.