



All in the family: Transferring a business to the next generation

Family businesses are all around us. Some are mom and pop shops and some are multibillion-dollar enterprises. In 2011, family businesses comprised 90% of all business enterprises in North America, and 62% of total U.S. employment, according to the Small Business Administration (SBA). Every family business has its own set of industry, ownership, and family issues to overcome. In general, about one-third of all family-owned businesses are passed on to the second generation, and only 10% are transferred to a third generation. Despite these statistics, it is possible to successfully transfer a family business to the next generation. Doing so requires early planning and a well-thought-out succession plan.

Benefits of keeping a business in the family

Often parents want and hope a child will take over the family business for several reasons, including:

- The emotional/psychological benefits of working together.
- Greater employment and financial opportunities for family members than available elsewhere.
- Maintenance of the family's focal point—the business. Parents see the business as the “glue” that helps the family stick together.
- Fulfillment of a childhood dream. A child has grown up in the business, knows it and wants to stay in it by acquiring ownership.
- Gradual retirement. The owner can stay semi-active in the business by gradually turning over operations and ownership to the new generation.
- Family pride and legacy. The owner takes considerable (and often justifiable) pride in continuing a family business and tradition.

Drawbacks of transferring a business to family members

For most business owners, this sounds great, but often, in reality, there are several obstacles to effectively transferring the business within the family. These include:

- The relationships among the children may not be harmonious.
- The children have personal career goals that don't involve the family business.
- The parents want or need to achieve their own financial goals before feeling comfortable transferring a business to children. The children, on the other hand, desire significant ownership sooner, rather than later.
- The children simply don't have the same desire, ambition or aptitude for running the business as the parents.
- The parents are dependent on some or all of the value of the business to achieve their personal financial goals, but the children do not have the financial resources to pay for the business.

Key Takeaways



Successfully transitioning a family business to the next generation requires early planning and a well-thought-out plan.



For the transfer and control of a family business from parent to child to be considered successful, three components should be in place: a strategic vision, a continuity plan, and a tax-efficient wealth transition plan.



When determining how to pass on assets to both business-active children and nonbusiness-active children, parents should strive to be equitable or fair in treatment, but not necessarily equal.

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Building an effective succession plan

For the transfer of business ownership and control from parent to child to be deemed “successful,” there are three components that should be in place:

- Strategic vision
- Continuity plan
- Tax-efficient wealth transition

Strategic vision

A successful succession plan requires all family members involved in the business to create a strategic vision for the company that takes into consideration each family member's point of view. The goal is to arrive at a consensus about where to take the business that incorporates each individual's aspirations. The following questions can be used to begin this discussion:

- What does our family business look like in five years?
- If you own stock in the business, are you interested in selling any of it? If so, to whom?
- Are you interested in buying stock and acquiring control?
- Do you agree that in the interest of maximizing shareholder value, this business can be sold to a third party at any time?
- Do you think we should continue to run the business and invest more into it or proactively pursue the sale of the company?

Continuity plan

Another critical piece of a family business succession plan is the continuity plan. Has the owner(s) taken the steps necessary to preserve and protect the business if (s)he unexpectedly dies or is incapacitated? The following questions can help you analyze this question:

- If you die unexpectedly, can your family continue to run the business? If not, who can?
- If you die unexpectedly or become disabled, will your family have sufficient liquid resources to hire someone to replace you and provide adequate ongoing capitalization?
- If you have multiple owners, is there a buy-sell agreement in place that provides for a reasonable valuation for the business and terms of payment if the business is sold?

- Do you have a management succession plan in place? A key part of this plan is a realistic determination of who in the family—if anyone—is willing and capable of taking over the business.

Tax-efficient wealth transition

A final critical part of the succession plan is determining the best way to transition your business to family in the most tax-efficient manner. Some questions you need to consider include:

- How much wealth do you want/need to “retire” or meet your personal financial goals?
- How much wealth do you want the children to have? Is there a maximum amount?
- Are you willing to make gifts of interest in the family business to your children, or trusts for their benefit, if you can maintain management control?
- Are you and your spouse in agreement as to the ultimate disposition of the family business?

Wealth transfer: Fairness vs. equality

Any discussion of family business transfers would not be complete if it did not include the topic of fairness versus equality. Most parents have a natural inclination to distribute every asset equally to all children. The thought of giving one asset, and very likely the most valuable asset, to one child is considered unequal and, therefore, unfair to the other children. Yet upon closer examination, leaving the business entirely to the business-active child (BAC) and making an equitable distribution of the balance of family assets to the non-business-active children, and perhaps to the BAC as well, can be the fairest plan of all.

Fairness in this context is usually a judgment parents make about what they think is fair to the children. However, it often overlooks what each child deems to be fair. This perspective is all too often missing in family transition planning. To determine what is fair, the parents should assume the point of view of both the business-active child and then that of the inactive child.

Why might a child who is active in the business resent having a co-owner sibling who is inactive in the business? Often parents will offer all of their children an equal opportunity to participate in the business and

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become owners. Yet it is the efforts of the business-active child to increase the value of the business that should be rewarded. If only one child seized that opportunity, why should parents force the most ambitious child who chose to succeed the owner to share the rewards with children who chose different career paths?

On the other hand, what about the perspective of children not involved in the business? First, children not involved in the business will generally prefer to own or receive assets that are more liquid and less risky than ownership in the business. This is usually true even if they have to wait until both parents die to receive their inheritance. Second, if inactive children own part of the business, have they received anything of real value? Partial business ownership will make an inactive child the proud owner of an illiquid security that may generate no immediate income or other benefits. Further, the inactive child has no ability to sell his or her interest, except to the business-active child, and it's likely that the active child won't have the money to purchase it. But even if (s)he does, the business-active child's idea

of fair market value is likely to differ dramatically from that of the inactive child.

How can you find the appropriate mix to ensure a successful family business transfer that plans for both the business-active child and the non-business-active child?

For most families, the decision comes down to a discussion of fairness vs. equality. Since there is likely a difference in contribution to the business and between assets being gifted (business vs. non-business and consequent timing difference), it is critical to be equitable or fair in treatment, not necessarily equal. Parents must strive to be fair and explain this strategy to all of the children. Often it is best for owners to hold a family meeting to communicate the discussion with the help of a trusted advisor serving as intermediary. By focusing on the most critical questions and considerations, owners of family businesses can work together with their children to design an optimal path for family wealth transfer that meets the owner's exit objectives as well as the children's aspirations.

For more information, please contact your Key Private Bank Advisor.



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