THE PRIVATELY HELD BUSINESS

KEEPING IT IN THE FAMILY:

LOVE, HARMONY AND A GOOD ESTATE PLAN

Keeping it in the family

There is much at stake with interests in a privately held business, especially when the discussions about passing those interests down or passing them on to third parties begin to take place. In this section, we take a look at the issues every business owner should examine when beginning a transition plan centered on keeping their business interests in the family.

Beloved family touchstone for current and future generations? Or prescribed and confining life path that limits individuals' pursuits of their own dreams? A privately held business can be these things — and much more. Beyond the opportunity for significant wealth for its owners, a privately held business often represents prestige, job security, control over financial destiny, multi-generational legacy and the very thing that gives the family its sense of "who we are." For those who have a strong desire to see a business continue in the family for generations, the business represents the entire spectrum of human emotions. At no other time are both emotions and hard business decisions put into as much play as when this question surfaces: "What is the next step for our privately held business?"

Family business trends and truths

At some point a family business — regardless of size — faces the issue of transition. Perhaps the founding, first-generation owners are facing declining health or a desire to have more time to enjoy the fruits of their labors. Or the second generation has successfully grown and managed the business and can now realistically visualize a transition to the third generation. Or perhaps the business itself is facing a critical juncture, with the need for fresh everything — funding, strategy, products, partners and markets — and a new generation of talent to make that happen. Unfortunately, the landscape is full of family businesses that failed, rather than succeeded, at their transition. As mentioned in the previous article, according to the Family Business Institute, 88% of current family business owners believe the same family or families will control their business in five years; succession statistics, however, undermine this optimistic belief. Only about 30% of family businesses survive into the second generation, 12% are still viable into the third generation, and only about 3% of all family businesses operate into the fourth generation or beyond.[1]

As straightforward as the statistics sound, some might suggest a different — more optimistic — interpretation of the data. For example, "survival" of a business, doesn't necessarily refer to a company that has ceased to operate because it lacks performance or competitive advantage to remain viable. Many family businesses don't "survive" because they are sold in exchange for significant profits, which are reinvested in other businesses or now managed as liquid wealth. The real question is not whether the business survives, but whether the family coheres and continues to do business together. Second, the track record for family business survival actually is better than most businesses that are not family owned. Fifty years ago, the life expectancy of a firm in the Fortune 500 was approximately 75 years; today, it's less than 15 years, and on the decline.[2] The average life span of less-capitalized companies is even fewer years. A family business that survives for two generations is beating the odds. Even with those qualifications, times of generational transition are times of great peril for family businesses. How do businesses and families survive? The answers are thought-provoking.

"One universal truth about very successful family businesses is that the family is able to take a very long-term view and recognize that the business must be run as a meritocracy," says Jeffrey S. Thomas, CFA, managing director of CIBC Private Wealth and a longtime counselor to many family businesses. "Certainly there is often a feeling that the business is like the founder's favorite child, but in the very best sustained family businesses, it goes beyond that: Succeeding generations feel a special duty of stewardship to improve it and care for it, even if that means looking outside the family for additional expertise to help run the company. Succession planning for a family business is probably the toughest challenge the family will confront," says Thomas.

It's imperative that the family clearly communicate and outline that the business is actively engaged in a succession plan. For the founding and active owner and spouse, the importance of planning can't be overstated, especially if the owner is anxious about giving up control or experiencing a possible change in financial security.

Of course, emotional considerations are only the start. A Barclays study of 300 family members in family businesses indicates that financial security for children is a significant consideration for business owners. In fact, 67% of business owners surveyed consider "providing financial security to dependents" as an important objective for wealth creation and protection, compared with 58% of nonbusiness owners. "Family business owners tend to be very paternalistic… They see their businesses as an extension of themselves, and having their children involved heightens their sense that taking care of the business is also taking care of the family."[3]

For this founding-generation owner and spouse, two sets of questions — personal finances and family considerations — are critical. "Establishing your own personal goals is first," says Halsey Schreier, senior wealth strategist and managing director at CIBC Private Wealth. "While some of these will necessarily overlap with family goals, the personal ones have every right to be addressed first." Broad goals include liquidity, family legacy, philanthropy and lifetime income; owners should work through both sets of questions for each goal.

Financial considerations:

- Will you be able to retire when you want?
- Will your surviving spouse be able to enjoy his or her lifestyle independent of the business interests?
- Is there enough liquidity to pay estate taxes so the family won't lose the business interests or see the business financially crippled?
- What estate and trust options should you consider?
- If you sell, how will the assets you receive be invested?
- What means of support do your children have?

Family/nonfinancial considerations:

- Do you want to keep the business interests in the family or sell them to a third party?
- Will the business interests pass only to the child or children who are active in the business? Are your children really competent to run the business? Are there other key employees who need to be retained?
- If they are not already, when do you want your children involved?
- How will you establish a "control" process to avoid family disagreements?
- Will you treat your children equitably or fairly? (There's a big difference.)
- Do you need to stay involved in the business?
- What are your charitable objectives?
- What is your comfort zone on: giving up control, deciding when and to whom, and paying gift taxes now to achieve your goals?

"For the business owner and spouse who are actively creating their estate plan concurrent with the business transition plan, the key is to find strategies to achieve as many of these competing objectives as possible in a tax-efficient manner," says Schreier.

What about the children?

Do they have "the will" and "the skill"? In a nutshell, that's what it comes down to when deliberating about whether the next generation should come into the privately held business — even for those businesses in which a second generation is already employed. "Most businesses, even small, family-owned ones, can't afford to stay at status quo," says Thomas. "So even if the owner's children are helping run the business now, it's imperative to examine whether they are the right choices to take the business to the next level. Particularly for a business that plans to bring in — and support in a meaningful way, both financially and emotionally — third and fourth generations, the business will **have** to grow."

The question, however, extends beyond the competence of the children to run the business. In many families, the rising generation must learn the skills and disciplines of thoughtful ownership and, even more importantly, they must learn to collaborate together as a sibling team. Business failures are not the results of poor planning; they are the results of failed family cultures. Families that are not bound by a common purpose and not characterized by trust and vibrant communication are unlikely to stay in business for long. Sometimes families can part peacefully, but often the separation is personally and fiscally ruinous.

Even if the family is able to overcome these obstacles, it faces daunting future challenges, particularly as the business transitions into the third generation. By one estimate, if a family is growing by two to three children per child, per generation, the business's profit growth rate must be 6% to 7% before inflation to maintain a constant dollar level of dividend payout per child. That means an overall growth rate of 10% to 12% after inflation. In a mature industry, a company's growth rate will mirror the population's growth rate — about 3% worldwide.[4] These statistics mean that the second generation must be willing to reinvest capital in the business to "front load" the growth of the family enterprises. This imperative to grow often means that the family must also diversify its wealth among different business interests and more traditional investments to keep pace with the encroaching "law of large numbers."

Beyond "will" and "skill," there are numerous important questions for the family to consider as it moves forward. The traditional model of the matriarch and patriarch making all of the estate planning decisions is breaking down rapidly. Increasingly, wealth holders are involving their children in the core questions of the estate planning process. Warren Buffett has said, "Your children are going to read the will some day. ...It's crazy for them to read it after you're dead. ...You're not in a position to answer questions — unless the Ouija board really works. I do think it is very important in wealthy families once the kids are a certain age ... they should be participants in the will."[5]

In this sense, estate planning is moving beyond a personal responsibility to a family responsibility. For those who say that their children couldn't participate in that discussion and who fear the involvement of their children in such decisions, one has to ask the question, "If they can't engage in even this simple discussion, what makes you think they will be able to be in business together over the course of the rest of their lives?" As it turns out, many founders find this kind of conversation provides great insight into what life will be like for their children after the parents are gone and shapes the planning in ways that will likely avoid disaster.

When picturing the children's potential role in the business, the founder needs to consider numerous questions: Is it simple "fairness"? How do you define "fair"? Is there an automatic right of entry? What are the "rules" to being an owner? What are the children's expectations? Does the second generation have the right to pass ownership shares to their own children? Or do those third-generation children have to earn their way in? And business owners mustn't forget one of the most basic questions of all, the one to ask as a parent: "Is being in this business right for my children at all?" "There's no fitting a square peg into a round hole," says Christopher M. Goodrich, a partner with Crady, Jewett & McCulley LLP of Houston. "The artistic child is not likely to have an interest or aptitude in finance. Be realistic — and compassionate. Your children don't want to disappoint you, but they have the right to make choices about their own lives."

Preserving family harmony

The family may also have to engage in decision-making that will seek to preserve family harmony — and in most family businesses, there is unavoidable tension between harmony and the demands of the marketplace. "Family

harmony is fostered by treating all children equally, thereby avoiding perceptions of parental favoritism," says Schreier. "But treating children equally may not be possible where the talents and abilities of children are unequal. As for the business, its survival is enhanced when only the most able of the children receive control over the family business. From the parent's perspective, giving the most able child a controlling interest in the business and making him or her the executive officer may appear to be both rational and fair, because that strategy promotes business survival. From the children's perspectives, however, the preference of one child over another child may appear to be favoritism."

The business owner may be tempted to try to solve this problem by simply making a decision, but any decision made is likely to backfire in the long run. No decision that is opposed by the family will survive long after the death of the last surviving parent. It is far better to craft a decision that involves those most affected. This process might require outside facilitation, and the conversations may be difficult, but the results of coming to an agreement before the death of the founder can preserve both family harmony and financial value. And if the family can't agree, the owner will have far more information to work with as he or she plans for transition.

Often, there will be tension between children already active in the business, or those who plan to be, vs. children who want no part of it but who benefit from it financially. The nonactive children may believe that the compensation and benefits provided to the active children are excessive, and they may question business decisions even when they know little about the operations, economics or competition of the business, says Goodrich. Active children may resent that their hard work to increase the value of the business benefits nonactive children, who did not make the same efforts on behalf of the business, failing to recognize that if nonactive children have equity ownership, they have a right to the economic benefit of the business. "We've seen many business owners who feel very conflicted when trying to treat their children fairly and also direct the vision for the business's future," says Goodrich.

Again, rather than attempting to resolve this question for the family, the wise family leader will ensure that the children are educated and informed about the issues, and then involve them in the solution to these dilemmas. (After all, it is the children who will have to deal with the consequences, and the last thing most parents want is to sow the seeds of inevitable dissension.) The more enlightened path is to resolve these issues in family conference. And, as before, if resolution cannot be reached while the parents are alive, it will almost certainly not magically transform after the last parent dies.

The business's value: Says who?

Business transitions must start with an understanding of the value of the business. Typically, that process needs to take into account the owner's nonbusiness assets as well. Many company founders have a mix of liquid and longer-term investment assets, business and personal real estate, life insurance, retirement accounts, trusts and tangible property. Some are easier to value than others, but the value of the business may be the most difficult. In addition, putting a price on the business raises issues the owner must consider carefully.

The attributes of successful and enduring family businesses

To be successful as both the company and the family grow, a family business must meet two intertwined challenges: achieving strong business performance and keeping the family committed to and capable of carrying on as the owner. Five dimensions of activity must work well and in synchrony:

1. Harmonious relations within the family and an understanding of how it should be involved with the business
2. An ownership structure that provides sufficient capital for growth while allowing the family to control key parts of the business
3. Strong governance of the company and a dynamic business portfolio
4. Professional management of the family's wealth
5. Charitable foundations to promote family values across generations

Source: "The five attributes of enduring family businesses," McKinsey & Company, 2010.

“For a sale to an outsider, you would generally prefer the highest valuation possible,” says Scheier. “But if you want to gift the business to your children or create an intrafamily transfer, a lower valuation is usually desirable. Even more complicated is if you plan to give it to only one child at a very low value. The children not involved in the business may feel that they know the business is really worth much more and that they are being short-changed.”

If your goal is to have a lower valuation to ease an intrafamily handover, there are numerous, and complex, techniques to do so. These include family limited partnerships, grantor retained annuity trusts (GRATs), private annuities and installment sales to defective grantor trusts that use valuation discounts to reduce significantly the cost of gifting business interests to family members.

While a formal business valuation, performed by a valuation firm, is needed for estate and family gifting purposes, it’s not necessarily used in the sale process itself. “When we sell a company, we don’t share outside valuation reports with potential buyers. The price is determined by the market,” says Ronald Miller, managing director, CIBC Cleary Gull.

Getting the business interests down to the next generation

Like any family, individual or situation, there’s no one “right” plan to transition business interests to the next generation. An individual plan must be designed to serve the interests of all parties — including the estate of the owners/founders. The most common situation is that some, but not all, of the owner’s children are active in the business. These situations, notes Schreier, present the most difficult challenges. “Ideally, the owner’s estate has enough assets to equalize the estate among all the children, with the business passing to the children working in it, and other assets passing to children not involved,” says Schreier. “Most often, however, the family business represents a disproportionate amount in the owner’s estate. In these situations, the business owner must find a way to provide equal distributions to all of the children, or accept a disproportionate distribution. Ideally, we can develop a plan that balances the owner’s objectives of maintaining family harmony, while the children active in the business continue on without undue interference from the children not active in it.”

Here are some of the more common techniques for moving business interests into the hands of the next generation:

Grantor retained annuity trust (GRAT): Using a GRAT, an owner can transfer a business interest to family members at a reduced gift tax value and retain the right to receive annuity payments for a fixed number of years. The annuity amount is a fixed dollar amount or fixed percentage of the initial value of the trust assets. After the trust term expires, the remaining trust property passes to the trust beneficiaries (the children). In addition, the annuity stream to the owner can be used to fund additional GRATs, creating “rolling GRATs.” The rules on gifting to a GRAT are very complex, even though they have a big advantage: years of strong case law and regulatory guidance. However, it is always important to be mindful of the potential for changing rules.

Transfer of the business shares, voting vs. nonvoting: This option essentially reorganizes the business to create two classes of interests, which allows the owner to gift nonvoting interests while still alive, yet retain the voting interests and control. Or, the owner can gift voting interests to both active and nonactive children.

Installment sale to children: Structuring an installment sale of business interests to one or more children revolves around the owner receiving at least one payment after the tax year in which the business is sold, which allows spreading the taxable gain over time and deferring a portion of the tax liability on any profits. Rather than a one-time payment (assuming the children could even do that) with an immediate tax liability, each installment payment is treated as return of capital, gain and interest income. Under this scenario, the owner must be willing to give up control of the business; the responsibility for it and its future appreciation rest completely with the children. An installment sale carries the advantage of more easily “equalizing” the owner’s estate if there are multiple children — they are, after all, purchasing the business, not receiving portions of it as a gift from the parents.

Installment sale to grantor trust: In this technique, the business owner seeds the trust with a gift of approximately 10% of the value of the purchase price of the business to provide equity in the trust. He or she then sells the business (or a portion of it) in exchange for an installment obligation from the grantor trust. Transfers between the trust and the business owner typically have no income tax consequences.

Life insurance as a planning tool for privately held business transition should never be overlooked: It is a simple and economically efficient way to provide liquidity and can equalize distributions among children, provide income to a surviving spouse, pay any estate taxes, or let children buy out the owner's interest. "Ideally," says Scheier, "the life insurance should not be included in the estate of the business owner. Otherwise, a portion of the life insurance will need to be used to pay estate taxes on the life insurance, making it unavailable for its intended purposes. The simplest way to address this issue is to have the children not active in the business apply for the insurance and have the owner/parent make annual gifts of the premiums."

When continuing income to the owner is a goal, numerous techniques can be used: Consider dividend distributions (as long as the retiring owner owns some interest in the business), consulting arrangements, or even noncompete payments. (Yes, mom and dad could actually be contemplating starting another business.) In addition, in business transition plans, don't forget to include possible future situations like divorce and remarriage. "This is often real life at its most vexing, but must be considered," says Goodrich. "When carefully structured and negotiated, and with the proper disclosures, pre- and post-marital agreements can provide substantial certainty with respect to the disposition of business interests in the event of divorce."

The question with all of these techniques is whether the family has the willingness and capacity to make them function. The family must be prepared through education, skills development and deep conversation to support the plan effectively and have the ability to make these plans productive, as designed. Plans that either generate entitlement or sow the seeds of protracted conflict may be tax-efficient, but often at an unacceptable cost in familial suffering.

Giving up and passing on a business is a major, life-changing event with a whole host of complex issues and often-difficult decisions. While it could result in family strife, if done well, it also has the potential to be a golden opportunity to realize business, family, legacy and philanthropic goals after years of hard work and sacrifice. ■

1 Family Business Institute, familybusinessinstitute.com/index.php/Succession-Planning. Data pulled September 2013.
2 "Fortune 500 firms in 1955 vs. 2014; 88% are gone, and we're all better off because of that dynamic 'creative destruction,'" American Enterprise Institute, 08.18.2014, aei.org.
3 "Family Business: In Safe Hands?," Barclays Wealth, May 2012.
4 "Common Features in Successful Family Businesses," Dr. Joe Astrachan, Family Business Radio, June 21, 2012.
5 "Lessons in Estate Planning from Warren Buffett" (includes excerpts from Q&A with Warren Buffett at the May 5, 2013, Berkshire Hathaway annual shareholders meeting), by Thane Stenner. The Globe and Mail, May 19, 2013.