SUCCESSFUL TRANSFER OF THE FAMILY BUSINESS

WHITE PAPER

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Introduction

What could be easier than transferring your family business to its natural successor: your heirs apparent, your offspring? If some of your first guesses were peace in the Middle East, increasing honesty in politics, or convincing a teenager that he or she might be wrong about something, you have probably witnessed your share of family-business transfer disasters.

Statistics widely quoted by Estate Planning writers indicate that “only” one-third of all family-owned business are passed on to the second generation, and “only” 10% of family-owned businesses are transferred to a third generation. Experience indicates that those statistics are wildly optimistic and overstated.

Pessimism notwithstanding, some family businesses are indeed *successfully* transferred to younger generations. For the transfer of business ownership and control from parent to child to be deemed “successful,” the parents must achieve all their Exit Objectives, including the following:

1. Financial independence and security completely divorced from reliance on cash flow from the business.
2. Intra-family fairness regarding the distribution of family wealth and businesses.
3. Complete transfer of business operation and ownership control to the younger generation. This usually means the parent is out of the business and is not needed in the business for any reason.

If it is so difficult to *successfully* transfer a business from one generation to the next, is there a way to improve the likelihood of success? Better yet, is there a no-fail recipe? This white paper will approach these questions and lay out strategies to help improve the chances that you transfer your business to your family successfully.

Reasons and Realities in Family Transfers

In the checkered but always-interesting history of nepotism (as it relates to business transfers), we find that parents hope a child will take over a business for several reasons:

1. The joy of working together. (At least that’s what some owners claim.)
2. Greater employment and financial security for family members than available elsewhere.
3. Maintenance of the family’s focal point, the business. Parents see the business as the glue that keeps the family together.
4. Fulfillment of a childhood dream. Their successors have grown up in the business, know it, and want to stay in it by acquiring ownership.
5. Gradual retirement. The owner can stay semi-active in the business by gradually turning over operations and ownership to the new generation.
6. Family pride. The owner takes considerable (and often justifiable) pride in continuing a family business and tradition.

Though these factors all sound wonderful, too often, your hopes and aspirations crash headlong into the brick wall of reality:

- The children don’t get along with each other.

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- The children have substantially different career goals.
- The children desire ownership before their parents are financially secure.
- The children simply don't have the same desire, ambition, or aptitude for running the business as the parents.

All business transfers are challenging, but family businesses face especially significant obstacles. Nonetheless, it is quite possible, given the right circumstances, to successfully exit your business by transferring it to your children.

There is a recipe for creating a successful intergenerational transfer. It isn't the only recipe that works, but because it depends on six carefully chosen ingredients, its chances for successful completion are greater than others.

If any of the following six ingredients are compromised, or worse, missing, the result will change.

- Parents must undertake their own version of The BEI Seven Step Exit Planning Process™.
- One business-active child becomes the sole successive owner.
- The business transition plan is *fair* to all children.
- Parents have achieved financial security (independent of the future cash flow of the business) *before* business ownership and control is transferred to the business-active child.
- The business-active child has demonstrated the capacity, ability, and willingness to run the business for a significant time period (at least three years) before the parents transfer control and ownership.
- There is a back-up plan.

Just as baking bread at sea level is not the same as baking at a high altitude, this is not a one-size-fits-all recipe. However, regardless of altitude, bakers use flour, yeast, and water, but quantities, temperature, and cooking time vary. Similarly, the transfer plan may need to be adjusted to your specific circumstances. For example, you may be able to include several children in business ownership.

These six ingredients are nothing more than a pattern of facts that, when present, enhance the chance of a successful family-business transition and often constitute the recipe that provides the most significant opportunity for success.

First Ingredient: Parents Undertake The BEI Seven Step Exit Planning Process

All business sales or transfers are challenging, but owners who want to transfer their businesses to children often find themselves in the middle of a transfer quagmire: Their children and spouses all have opinions about how they should exit, and they are not afraid to share them!

If you find yourself in this position, we have one suggestion: Get off the rollercoaster. Undertake the process that savvy owners use to plan successful exits: The BEI Seven Step Exit Planning Process. This Process will enable you to craft your own exit by accounting for the concerns of all family members. Believe it or not, this Process can integrate all points of

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view into a single, unified strategy. It organizes your priorities and is easily modified to reflect considerations unique to family business transfers.

The following list comprises the Process's Steps:

Step One: Establish parents' objectives.

Step Two: Determine company's value and cash flow. Evaluate business-active child's contribution to both.

Step Three: Increase business value (through incentive planning for key-employee group and/or business-active child).

Step Four: Sale to third party (not applicable to this white paper).

Step Five: Transfer to insiders: Design the sale/gifting of the business interest to the business-active child.

Step Six: Business-continuity planning (in case either parent or business-active child dies).

Step Seven: Wealth-preservation planning (estate and gift planning to level the playing field for all children).

Let's look at each Step in more detail.

Step One

You may have a number of Exit Objectives, but you should establish, at the outset, at least these three:

- How you (and your spouse) define financial independence.
- How you and your spouse define fairness, regarding distribution of family wealth (including the business) among children.
- When you (and your spouse, if active in the business) want to leave the business and transfer control according to a time frame you set.

Establishing these objectives will serve as the foundation for your entire Exit Plan.

Step Two

In addition to knowing what you *want*, you must know what you *have* (i.e., the value of your company) before you can plan your exit. In the transfer of a family business, business value must be determined and the business-active child's (BAC's) contributions must be considered. Often, parents reduce business value by the amount of the BAC's past contributions so that he or she does not pay for his or her contributions to value.

Additionally, a current value can be used as a base so that any future growth in value (if not due to the active parent's efforts) is typically attributed to the BAC. Again, the purpose is to keep the BAC from paying for his or her own "sweat equity."

Step Three

Once you know what you want (Step One) and what you have (Step Two), you must think about how you can motivate key employees (including the BAC) to increase the value of the company and remain with the company through the transition.

Step Four

Step Four is a transfer to an outside third party, so it does not apply to family business transfers.

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Step Five

In this Step, you design the transfer of ownership to your BAC (and possibly some key employees). This is often accomplished through a combination of gifting and selling, depending on your financial needs and other wishes.

Step Six

It is critical to make contingency plans for what will happen if the business-active parent dies before the transfer can be completed (e.g., should the BAC receive the business via a buy-sell agreement or bequest at death? Should ownership first transfer to the surviving spouse before an ultimate transfer to the BAC?).

Step Seven

All owners undertake wealth-preservation planning, but this Step is absolutely critical in the transfer of family companies. It is through estate and gift planning that parents provide for their non-business-active children. The considerations in this Step involve a balancing of the fairness issues that arise in every family transfer.

Second Ingredient: One Child Becomes the Sole Successor

It is easy to recognize business owners who have dedicated their lives to ensuring a successful transfer of a family-run business: They have only one child. For most of us, it is a bit late to reverse course. The following explains why owners should prefer that only one child succeeds the parent.

There are two possible ownership scenarios for families having more than one child. The first is that more than one child is active in the business. In that case, the predominant issue is to determine how multiple children are to share the control and ownership of the company. The second is having one BAC and one or more children who are inactive in the business. The primary concern in that case is to give the business to the BAC while being fair to everyone else (Third Ingredient, discussed next).

Owners in the first situation must ask themselves, "How can children who couldn't share a cheap toy when they were younger now share the ownership, management, and control of a successful, multimillion-dollar business enterprise?" Forcing the children to work together ordinarily creates an unnatural coalition of differing talents and desires, united only by bloodline.

Contrast that situation with business partnerships that do work: Two or more individuals enter voluntarily into a business arrangement for their mutual benefit, each contributing experience, talent, and perhaps money. In return, they each receive an agreed-on, negotiated ownership interest in the business, which is a proportion *they* agree on, not a proportion given to them by someone else. Further, they are likely to have similar goals, aspirations, drives, and abilities. Hoping to enhance the likelihood of business success brings them together, not family ties.

Family ties of a different sort can also create dissension and discord. Adult children who, years before, found sharing a toy difficult (if not impossible) because of sibling rivalry now find another relative introduced into the mix: their

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spouses. The influence of a spouse on a child's business decisions can be akin to trying to put out a fire with gasoline. Thus, co-ownership among siblings is rarely permanent, especially once the parents are out of the picture.

As a business owner, you know many other owners. How many of them share ownership equally with a brother or sister? Most likely, almost all owners you know are the sole owners of their businesses, unless they have sold or transferred a small minority interest to one or more key employees.

Equal ownership of a business with even an unrelated person is an odd bird in the business world for good reason. Successful entrepreneurs are notable for above-average amounts of desire, drive, ambition, dedication, and commitment to their businesses. These are not personality traits that work well in a cooperative environment. They are attributes born of the simple fact that they own and are responsible for those businesses. Sharing that burden, although tempting at times, is not a route most owners voluntarily take.

In many family-run businesses, the parent did once co-own the business with one or more brothers or sisters. Over the years, those siblings dropped out or were bought out of ownership. It would seem that co-ownership just doesn't work for most families. It's unlikely to work for yours.

This second ingredient, transferring the business to one child, must now be blended with the quest for the third: fairness to all children.

Third Ingredient: A Business Transition That Is Fair to All Children

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 BAC *and* making an equitable distribution of the balance of family assets to the inactive children is the fairest plan of all.

"Fairness" in this context is usually a judgment parents make about what *they* think is fair to the children. What it overlooks is what the *children* deem to be fair to each of them. This perspective is often missing in family transition planning. To determine what is fair, assume the point of view of the BAC and then that of the inactive child.

Let's look at why the BAC might well resent a co-owner sibling who is inactive in the business.

- It is the efforts of the BAC to increase the value of the business that should be rewarded. You probably offered all of your children an *equal opportunity* to participate in the business and become owners. However, only one child seized that opportunity. Why force your most ambitious, risk-oriented child—the one who chose to succeed you—to share the rewards with children who chose different career paths?

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- You had no co-owners in the business because you wanted to operate the business independently. As an entrepreneurial "chip off the old block," your child doesn't want to share ownership any more than you did.
- The controlling vote is not enough. When there are co-owners, the child running the business has a fiduciary duty of due care and loyalty to all other shareholders. That means that the BAC's actions, such as giving him or herself a bonus, increasing his or her own salary, or indulging in other business "perks" (as you do), must all be reasonable and comparable to what a non-shareholder performing the same duties for the company might reasonably expect. It can be difficult to subject *your* compensation and perks to the same level of scrutiny.

What about the inactive child's perspective? Inactive children are unlikely to want ownership in the business, if other choices are available.

- Inactive children generally prefer to own or receive assets that are more liquid and less risk-oriented than ownership in the business. This is usually true even if they have to wait until both parents die to receive their inheritance.
- If the inactive child owns part of the business, has he or she received anything of real value? Partial business ownership will make the inactive child the proud owner of an illiquid security that generates no immediate income or other benefits. Further, the inactive child has no ability to sell his or her interest, except to the BAC. Ironically, that's hardly a problem, since the active child won't, in all likelihood, have the money to purchase it. Besides, if the BAC does have the money, the BAC's idea of fair market value is likely to differ dramatically from that of the inactive child. In short, transferring a piece of the business to a business-inactive child will pit that child and the BAC against each other.
- It would seem from the previous point that the inactive child's ownership interest would have little value. The IRS begs to differ. While a non-controlling ownership interest can certainly be discounted in value, it will nevertheless rise in value as the overall business value increases (due to the efforts of the BAC). Because it is difficult for the inactive child to get rid of the ownership, he or she has to deal with tax consequences he or she otherwise could have avoided.
- Keep in mind that the inactive child will not be able to make any decisions regarding the future course of the business.

If only one child should own the business, how do you find the third ingredient—fairness to all children—when transferring the business to the BAC and other assets to the inactive children? Obstacles to a *fair* transfer of assets include the following:

- The business value may be significantly greater than the combined value of the remaining family assets.
- If part of the business value is attributable to the BAC's efforts, is it unfair to consider that part of the business to be that child's interest now? How do you determine the BAC's contribution to existing business value?

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- Let's not forget the timing issue. It makes good business, income-, and estate-tax sense to transfer a significant amount of the business to the BAC *during your lifetime*. However, inactive children will not likely receive their "share" of the family wealth until after you and your spouse have died. The reason for this is simple: The non-business assets are usually retained by you to provide income and financial security for you and, after your death, your spouse. The resulting timing difference is mitigated by the liquidity difference in the assets the children receive. The BAC may receive assets now, but his or her assets are highly illiquid and subject to business risk. The inactive children may have to wait, but the assets they receive will be highly liquid and relatively risk-free.
- In addition to the present difficulty of distributing business and non-business assets equally, there is an added difficulty of measuring the *current value* of the business interest given to the BAC against the *future value* of the bequest given to the inactive child. To understand the present vs. future value conundrum, consider the following:
    1. Is the BAC, in effect, paying for the business now through "sweat equity" (e.g., lowered compensation, more working hours, and greater risk)? If so, the current gift is not really a gift, but rather recognition of that child's efforts.
    2. Is the BAC adding to the business' value through his or her efforts? If so, he or she should not have to pay for that effort by receiving a reduced share of the ultimate estate.
    3. Has the BAC, by continuing in the business after your retirement, become a critical element in your retirement plan by ensuring that the business can pay you any deferred compensation and purchase your stock? If so, the means by which you tie him or her to the business—the golden handcuffs—may be the transfer of stock. Again, acquiring stock because it benefits you should not penalize the BAC when it comes to sharing in the estate.
    4. Is the BAC paying for part or all of the business?

How can one possibly find the correct measure of this ingredient?

For most families, the decision ultimately comes down to a discussion of fairness vs. equality. Because of differences in contributions to the business and differences between assets being gifted (business vs. non-business and consequent timing difference), it is imperative to be *equitable* or *fair* in treatment, not necessarily *equal*. Parents must strive to be fair. They must communicate and explain this strategy to all of the children. Often, it is best to hold a family meeting, using advisors to facilitate the discussion if necessary.

Finally, be certain to make appropriate adjustments in your will, trusts, and buy-sell agreements to apportion assets if your lifetime transfers of the business and other assets are not completed before your death. As part of those documents, the BAC should have the right to have his or her share of your estate consist of business interests, while the

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remaining children have the right to have their portion of the estate satisfied with other interests.

Transferring the business to multiple children.

At this point, are you still committed to attempting a transfer to more than one child? If so, is it possible to create a workable model?

Yes, although a successful multiple-ownership transfer usually requires a business that is sufficiently sizable and profitable to enable each child to run a separate division. Each child's compensation can then be based on the success of that particular division.

For those of you who still wish to sail against the wind and transfer the business to multiple children, we offer the following characteristics present in businesses that have been successfully transferred to multiple BACs:

- Family loyalty and family values are stronger than "business values" or the desire for personal gain. In other words, each child views business success through the eyes of the family and each of its members, rather than through his or her own eyes.
- One child has effective day-to-day control of business operations. Usually, control is granted to that child not because of stock ownership but because of the child's experience and leadership abilities.
- The business is large enough to support all children and give each child a separate area of responsibility.
- Each child's salary is based on job description and performance.
- Children have been active (alongside parents) in the business long enough to make each child comfortable with the role each plays within the business.
- Alternatively, the business must be large enough to be considered an investment (i.e., mature, solvent, stable, usually run by non-family managers as well as one or more children, and sufficient cash flow to handsomely reward the BAC while providing an income stream to other children who are simply passive investors).

Fourth Ingredient: Transfer of Ownership and Control to the BAC *Follows* Parental Financial Security and Independence

The business is the primary source of wealth and income for almost all owners. As an owner, you should have all of the desired cash in the bank *before* you transfer control and ownership. Financial security comes in three basic varieties: those who have it, those who know how to secure it, and those who have the means to obtain it.

1. Those who have financial security can afford to receive less than full fair market value for their businesses. They have typically attained financial security by accumulating financial wealth outside the business. They have invested excess earnings outside the business during their active years.
2. Those who know how to secure financial security commonly purchase assets outside of the business and lease those assets back to the business for use. Assets purchased

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for lease typically consist of office space, warehouse/manufacturing facilities, or equipment used by the business. Keeping these types of assets outside the business lowers the value of the business, thus easing its transfer to the BAC by incurring fewer transfer (i.e., gift or estate) taxes. Second, keeping assets outside of the business makes those assets (or that wealth) available for transfer to the business-inactive children. Finally, keeping assets outside the business protects them from future creditors of the business after the parent has left.

3. Those who possess the means to achieve financial security are able to sell their businesses for cash to the BAC. *A business owner should not consider, even for a moment, transferring control, either operational or ownership, before financial security has been achieved.* If an owner wishes to leave the business before accumulating enough wealth to be provided with sufficient independence, then it is incumbent upon the BAC to obtain financing in order to pay sufficient cash for the ownership interest.

As a business owner, you must determine which flavor of financial security suits your palate. Keep in mind that even if your financial security does not depend on receiving full market value for your business, you must either insist upon it or accept the fact that by accepting less, you are giving away at least a part of the business. Once you start giving things away, the fairness issue crops up. If you don't handle these fairness issues through your Estate Planning documents, your recipe has become, at best, unpalatable to the children.

Some of you may have noticed that financial security did not include selling a business to the BAC, over time, for little or no cash. Although this course of action is all-too common, it is fraught with peril and usually doomed to fail. At the outset of this white paper, we established that we would provide only *successful* recipes. Hence, we have not included this option, as it is more often unsuccessful than successful.

Finally, parents who sell the business to the BAC for cash must begin the transfer process before they begin retiring. Under the best circumstances, the "modified cash method" requires that the "pump be primed." A child must receive significant ownership before acquiring the balance of the company for cash. If the transfer is to occur over an extended period of time, it is vital that parents retain ultimate control and subject the stock transferred to the child to a buy-back agreement. In this agreement, the parent will want to be obligated to repurchase any interest from a BAC so that if he or she chooses not to complete the buy-in process, the parent can execute his or her backup plan.

Fifth Ingredient: The Chosen Child Has Demonstrated His or Her Capability and Willingness to Run the Business for a Significant Time Period (at Least Three Years) Before the Parents Leave

How does a parent know whether a child is capable and willing to run and own a business? One of the best indicators is the parent's past willingness to take extended vacations without

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calling the business to just "check up on things." Of course, handling day-to-day issues does not tell you whether the child is capable of being a long-term owner who can handle larger issues of growth, future competition, and economic downturns. Your job is to prepare the child for future business risks as you would any key employee: with training, responsibility, education, and examples. It is at this point that the assistance of advisors can be most valuable.

Sixth Ingredient: Having a Backup Plan ("Plan B")

As one assembles and prepares the ingredients for a recipe, any number of things can go wrong. The same is true for an intergenerational business transfer. That is why having a backup plan is crucial. Let's look at the most common causes for employing your Plan B.

- If you die or become incapacitated before the transition is complete, your Estate Plan (i.e., wills and trusts) must assure the transfer of the business to the child or children of your choice.
- If the business has increased in value to such a point that a buyout by a child is too financially difficult, you must be prepared to offer the business for sale to a third party.
- Even if your child is able to purchase a highly valuable business, you may not be able to provide assets of equal value to your other children. Remember that fairness is a crucial ingredient for a successful transfer.
- Similarly, some businesses become too complex or too sophisticated for any one person to run and control. No child can be expected to shoulder that burden successfully. In this case, a better alternative is to sell to a third party (although professional management is a possibility).
- As time passes, you may discover that the BAC does not possess the drive or interest to carry the business. His or her desire to please you may have blinded you to his or her lack of ability or willingness to assume risk. He or she may not have fully understood the personal and financial sacrifices necessary to continue the success of the business. Again, a sale to a third party may be a better option.
- Finally, as parents and the child move through the transfer process, substantial differences in management style and practices may emerge. Sometimes, these differences can be overcome, but often they are so great that the transfer cannot be completed. It is imperative that if the transfer falters, the BAC's ownership interest can be reacquired by the company at the lowest defensible price. This is best accomplished through binding buy-back agreements between the company and child.

For all of these reasons, it is important that a backup plan exists. If the business transfer goes awry, you must have a Plan B.

Conclusion

Owners do not suddenly and decisively opt for a particular exit strategy involving their children. Usually, family and business lives become entwined when children first begin to work in the business after school and during summer vacation. In such situations, many

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unspoken assumptions are made and promises given, often well before the full consequences of those commitments can be appreciated. In other families, careful consideration, adherence to the recipe, and action, including the use of professionals, underlie the transition of the family-run business.

To increase your chance of successfully completing an intra-family transfer, you must focus on the six ingredients:

- Parents must undertake The BEI Seven Step Exit Planning Process.
- One child as sole successor (with exceptions, as noted).
- Fairness to all children.
- Owner's financial security precedes transfer of ownership or control.
- Child demonstrates ability and willingness to carry the business.
- Existence of a clearly understood backup plan.

Including these six ingredients in your Exit Planning Process will give your insider transfer the best chance for success. For more information or guidance, please contact us today.

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