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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' pursuit 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 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.

Whatever the reason for thinking about the transition of the business, 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, especially if the owner is anxious about giving up control or a possible change in financial security, can't be overstated, says Christopher M. Goodrich, a partner with Crady, Jewett, McCully & Houren LLP of Houston.

"A business owner is confronting his or her mortality when developing a succession plan, an obviously delicate topic made even more sensitive by the owner's dedication to his or her business. In addition, many entrepreneurs treat their business as another child that they have raised and nurtured, resulting in control issues that may interfere with the transition of the business to the next generation," says Goodrich. "The current and future role of the owner's spouse must also be explored. Depending on the spouse's relationship to the business, it may be appropriate for the spouse to succeed to ownership and/or control of the business upon the owner's death or incapacity or to act as a figurehead for the business, even if serving as the CEO of the business in name only. The spouse also frequently has influence as the 'chief emotional officer' within the family. The owner's feelings about passing on the business to the next generation may not be the same as the spouse, who is looking at issues from different perspectives."

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 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 you and your spouse (and the survivor of you) be able to enjoy your 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, 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 Jeffrey S. Thomas, CFA, managing director at CIBC Private Wealth and a long-time counselor to many family businesses. "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 often are not the results of poor planning; they are often 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. As a family grows and possibly becomes more reliant on the business for living expenses, the second generation often 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."[1]

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 considering 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 Goodrich. "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 some children are involved with the business and others are not. The business's survival is generally enhanced when the most able and involved children retain control of the business. From the parent's perspective, those children retaining control may be a rational and fair solution because the business is set up for continued success. However, from the children's perspectives, this may appear to be favoritism of one child over another."

The business owner may be tempted to try to solve this problem by simply making a decision alone, but any such decision 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 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.

The business's value: Says who?

A starting point for the planning process is a business valuation and a valuation of nonbusiness assets. 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, it raises issues the owner must consider carefully.

"For a sale to an outsider, you would generally prefer the highest valuation possible," says Schreier. "But if you want to gift the business to your children or create an intra-family 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 believe the business is really worth much more and that they are being short-changed." There are numerous, and complex, techniques to gift business interests (see discussion below) and many of the techniques use valuation discounts to reduce significantly the cost of gifting business interests to family members.

The business's value can be determined in one of three ways: cost approach (adjusted book value analysis), income approach (discounted cash flow method) or market approach (comparable company analysis). Both positive and negative attributes that affect value must be considered. Positive ones include repeat/recurring business, being a market leader, holding patents or a technological advantage, having a diversified customer base and being in middle-stage growth trajectory. Negative attributes can include discounting the value because of small size and the loss of the key person (the founding owner), being a cyclical business, having a commoditized and nonproprietary product or

service, or being in late-stage growth trajectory. An experienced business valuation consultant is a necessary part of the business transition planning team and will be most effective knowing the owner's goals upfront.

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. 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 active children and nonvoting interests to 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. The business owner 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: A life insurance policy can be 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 Schreier, "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."

When continuing income to the owner is a goal, numerous techniques can be used: dividend distributions (as long as the retiring owner owns some interest in the business), consulting arrangements, even noncompete payments. (Yes, the owner could actually be contemplating starting another business.) In addition, don't forget to include in business transition plans 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 "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.

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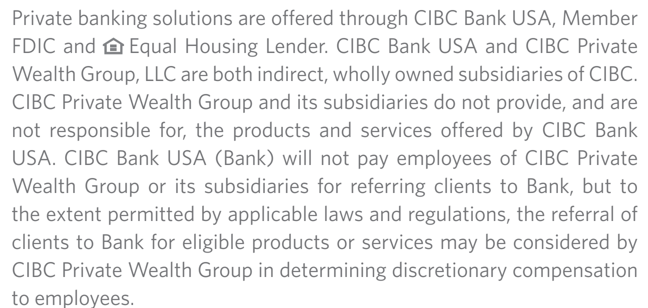

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