Successfully Transferring the Family Business: A New Methodology

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Abstract: *Family-owned businesses face many challenges in continuing through the generations. In order to assure the successful transfer of the business within the family, the owner and business should work with their advisors to 1) assure survival, 2) plan for the exit of the owner, and 3) fund the transfer plan. This article offers a new methodology for this process, a methodology geared toward the economic challenges of today.*

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The oldest family-owned business operated in the United States is over 386 years old.[1] Yet, fewer than a third of family-owned businesses survive into the second generation, 12% to the third, and only 3% to the fourth generation.[2] In many cases, the poor survival rate is simply a reflection of economics. Not all businesses are destined to survive. In some cases, however, otherwise successful family-owned businesses fail simply because they had no plan for business continuation. By employing advisors and following a planning methodology, these businesses have the opportunity to thrive throughout the generations.

A family-owned business is, for planning purposes, any closely held business where the issues of family relationships among the owners and key employees impact the business as a whole. This article provides an overall methodology advisors can use to help these families succeed in transferring their business within the family. It offers this process, recognizing the constraints and challenges of the current economic environment, and it assumes the family-owned business will ultimately employ a team of advisors to design and execute the transfer plan.

There are myriad challenges in transferring a family-owned business. This is perhaps why no one professional discipline (law, accounting, financial services) has become the profession of choice for business owners seeking exit planning services. A planner who seeks to assist the business owner must navigate several different technical areas and coordinate them all. Because of the disparate issues that must be grappled with in business continuation planning, it is important the planner have a methodology to design, execute, and monitor the transfer plan.

Core Strategies

In creating a family transfer methodology, there are three key areas the business owner must attend to if the family business is to be passed on successfully. First, both the business owner and the business itself must survive financially. Success cannot be claimed when, as a result of the transfer plan, the business is so financially impaired that the long-term likelihood of the business's survival is doubtful. For example, if the terms for selling the business from parent to child are so onerous that they burden the child's ability to operate the business, the plan is a failure. Similarly, if the transfer plan financially devastates the owner and family, the transfer plan has likewise failed.

Second, the owner must have a plan for exiting the business. Exit planning expert John Brown notes that one way or another all business owners must eventually exit their businesses. The exit-planning process is intended to help the business owner leave on his or her own terms.[3] The actual exit may occur years in the future, but in order to create a successful family business transfer, an exit strategy for the owner should be created in advance. The elements of the plan may include a sale, a gift, capital transfers, or a combination of techniques. While the goal is to create business continuity within the family, the actual process must involve specific exit event(s) for the owner.

Third, the plan must be funded. Too often, business succession planning is equated with buy-sell planning. Create the buy-sell documents, and the job is done. Unfortunately, many family businesses do not survive, irrespective of whether they have a buy-sell plan in place. Lack of funding is a likely culprit. Funding comes in many forms: financing, insurance proceeds, tax advantages, earnings. The successful family transfer plan must both create and anticipate the forms of funding that will be used to execute the transfer.

Step 1: Survival for the Owner and Business

If the baseline requirement for a successful family business transfer is survival, the planner must deal with both personal financial planning and business management issues. Further, in the unprecedented economic environment challenging all businesses at this time, the plan should include a course of action specific to current market conditions. The following itemizes some of the steps that should be taken to assure that survival issues, both owner and business, are addressed.

Financial Analysis

A family-owned business, by definition, does not have the same level of scrutiny and governmental oversight as a publicly held company. Strict financial reporting standards apply with publicly traded companies so that the stockholder can decide when to both invest and divest of ownership. When a family business decides to create a transfer plan, it is important to acquire similar financial information, particularly in the area of business valuation.

Even though the goal is to transfer the business internally, a true business valuation is a key step in the transfer planning process. Some reasons include:

- If any kind of financing will be involved in the transfer plan, the financing entity will likely demand an accurate valuation. The valuation may not only be an issue for underwriting the loan; it also may determine the source of the loan and interest rate charged. There are typically minimums and hurdles that apply for nontraditional financing outlets such as mezzanine lenders, private equity firms, and other nonbank lenders.
- Federal income, gift, and estate taxes may require a defensible valuation. For example, consider how an accurate valuation will be needed for federal estate tax purposes. First, the valuation may play a key role in the value assigned to the deceased owner's interest in the estate tax return.[4] Further, it will affect specific relief tax provisions such as special use valuation,[5] IRC 6166 deferral of payment of estate taxes,[6] and treatment of redemptions used to pay taxes and final expenses under IRC 303.[7]
- If the issue is to assess the survival prospects of the business, it is difficult to make this assessment without having a true picture of the company's value, earnings, and expenses.

A going concern valuation for transfer planning purposes is typically dependent on both a look back and look forward of earnings. The intent of the business analysis is to acquire an accurate valuation of assets and a reasonable assessment of future earnings and good will. With this information, the process of determining the prospects for the business's survival can begin.

The valuation of a family-owned business is not simply a task of updating the company's financials. There are several adjustments that are commonly necessary. For example, in some cases, a valuation adjustment is needed to reflect that the owner-manager is being paid a salary in excess of what would be paid a nonowner manager in a comparable business. In other cases, the owner may be taking less compensation than would be needed to attract a similar nonowner outside manager. Similar adjustments may apply to benefits, travel, company cars, and other discretionary expenses.

Additionally, the financial analysis must look at the personal needs of the owner and family. What is needed for retirement, for income continuation for the spouse, and other financial concerns particular to the owner? Compared with affluent individuals who are only wage earners, business owners have an added challenge in determining these retirement and related financial needs. Their financial plan must include the business financials and the expected outcome of the business transfer plan.[8] The personal financial plan should be adapted to model cash flows and tax effects from whatever business transfer plan is devised.

Financial Gaps

The U.S. economy is in the worst condition it has been in in more than 50 years. This publication has recently featured numerous articles on the implications of financial insecurity in the marketplace. Any family planning the transfer and succession of its business must recognize the challenges created by the economic downturn. A way to factor in the current down market is to analyze the financial gaps that the downturn has created for the business owner. By reviewing these financial gaps, the owner can better factor in current economic challenges without losing a long-term perspective. Five key financial gaps the owner and family should consider are:

1. *Retirement Gap*—A personal retirement income goal beyond what is currently filled by Social Security and a qualified retirement plan.
2. *Market Gap*—Current amount of capital versus the amount needed to accomplish financial goals.
3. *Business Value Gap*—Difference between book value and fair market value of the business.
4. *Estate Value Gap*—Variance between what the owner planned to pass on to heirs and beneficiaries and what is actually available.
5. *Government Gap*—Gap between what the government has promised and what will actually be delivered.

Family Factors

In *Every Family's Business,* author William Deans writes, "I have yet to meet a business owner who invited his or her children in the business because he or she disliked them."[9] There can be no transfer of the family business without family being considered in the equation. Dean proposes the formality of a family contract in the form of a 12-question "family blueprint." This way, the continuation or sale of the family business is formally reviewed and assessed on an ongoing basis.

Whether a formal contract is adopted or a simple analysis of the family situation is performed, the owner must consider the psychological aspects of the family-owned business. For most family-owned businesses, the primary considerations are:

- Control—Who's in charge, both in the family and the business?
- Equity—How will family members be treated equitably when they have different positions in the business?
- Jealousy and loyalty—What are the family and business politics?
- Conflicts and disruptions—What situations could cause confrontations, and how can they be avoided or resolved?

Overall Business Concerns

A family business transfer plan cannot be created in a vacuum, exclusive of other business financial issues. The business owner typically has several long-term financial issues to address:

- Survivor needs—What will happen to my family's income if I die prematurely?
- Income protection—What will happen to my income if I become disabled?
- Business protection—What can I do to protect and indemnify my business from loss of key employees, through death, disability, or loss to competition?
- Retirement—How will I assure that I don't outlive my assets?

- Exit planning—How can I leave my business on my own terms?
- Wealth transfer—How can I transfer my hard-earned wealth to my planned beneficiaries, in the way I want, without a significant loss due to taxes and other transfer costs?

These long-term financial issues are more than what most business owners and their advisors can handle in any one plan. For this reason, the owner should prioritize the planning process, putting the most pressing needs on top. Assuming, however, that the owner is willing to tackle planning for the transfer of the family business, it is incumbent that the owner considers these other financial issues in designing the transfer plan. For example, the owner may choose to temporarily delay the execution of a business protection plan while the transfer plan is being designed. But, the issue of assuring that the company will be protected from the loss of a key employee must still be factored into the transfer plan, because the goal is to assure the survival of the business.

Figure 1 summarizes the steps that should be taken in a business and family survival analysis. There is no one right way to accomplish each of these steps, but it is important that each step has been considered.

Step 2: Exiting the Business

Three Primary Purposes

A business may continue, but an owner must exit. Even if the owner wanted to, he or she cannot simply hand the business keys to the children and walk away. At a minimum, there must be a legal transference of the ownership interest. An essential step in any family business continuation plan is an exit plan for the owner. In his seven-step exit strategy process for business owners, author and exit planner Robert Gellman's fifth step is "Run your business with the goal of leaving it in mind."[10] The idea is to include exit strategies as a regular part of the business plan. Even when the plan is for the business to continue in the family, the owner must assume his or her exit.

Exit strategies must serve a purpose. There are literally hundreds of techniques that can be used to exit a business, each having its own advantages and disadvantages. A way to sift through these techniques is to determine which of three primary objectives they accomplish.

Maximize Value

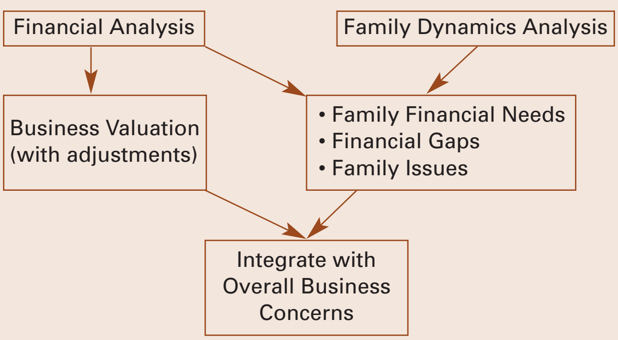
When a business is sold to an outside party, the owner typically seeks to maximize the value of the business in order to receive more cash. With a transfer of the business within the family, this may or may not be an objective. For example, if the owner is concerned about having adequate retirement equity, the exit plan may be designed to maximize the value of the business being sold to the children, siblings, or other family members. This may be accomplished with a straightforward installment sale. In contrast, if the owner is wealthy and is more concerned about taxes, maximizing the value may be counterproductive. Transferring the business for maximum value may increase the owner's taxes while straining the business's cash flow. Instead, the owner may want to maximize discounts and use techniques like a grantor retained annuity trust (GRAT) or grantor trusts to minimize the value for transfer tax purposes.

Minimize Taxes

The fair market value for transfer purposes does not alone determine the profitability of the transfer of a family business. As noted above, a significant concern may be taxes. When an owner exits a business in a single sale transaction, a significant lifetime issue may be income taxes, and at death, there may be a sizeable estate tax liability. For this reason, exit techniques are often designed to minimize, spread out, or otherwise recharacterize taxes.

FIGURE 1

Step 1: Business and Personal Survival



For example, in the sustained bear market being experienced currently, a business owner may not use a sale at all. If the business is to stay in the family, the owner may utilize a net gift strategy.[11] A net gift is a transfer made on the condition that the donee pays the gift tax. With this technique, the owner gifts the discounted value of the business to the children, subject to the children paying the gift tax. The children finance the payment of the gift tax through a low-interest loan from the parent. This technique minimizes transfer taxes, which, for some, may be a bigger concern than capital gains taxes. This is one technique among many that lower transfer taxes.

Maximize Flexibility

A common impediment to exit planning is the owner's resistance to committing to an exit strategy until immediately before the actual exiting event (death, disability, retirement, sale). While the more time allowed for design of an exit strategy leads to a better design, it can also tie the owner to an unwanted course of action.

In creating the exit strategy, a primary objective should be assessing how the techniques line up with the owner's need for flexibility. If the actual exit is not expected to occur until some time in the future, it may be advisable to have the exit plan include flexibility features. For example, a wait-and-see buy-sell is a common technique in which the agreement between owners provides that the corporation has the first option to redeem the exiting shareholder's stock; the other shareholders have the second option to purchase remaining shares; and, to the extent any shares remain unsold, the company must redeem the remainder. In a family business transfer, this gives the family the flexibility to determine which course of sale will minimize taxes.

Three Primary Techniques

There is no limit to the number and combination of techniques that can be used to exit a business. However, a recent family business survey finds that only 37.4% of such businesses have buy-sell agreements or other arrangements defining who can own stock and how it is transferred.[12] The very flexibility of transfer methods available may be a reason family businesses fail to arrive at a plan. In order to put a structure to the techniques available, and thereby make the selection process manageable, the transfer concepts can be divided into three primary techniques: sale, capital transfer, gift, or a combination of the three.

Sale

A sale can occur in many ways: forced liquidation, direct sale, buy-sell agreement, or by exercising a stock option. In the family-transfer situation, the sale is often straightforward. If the sale is to be immediate, one family member sells to another family member. If the sale is to occur in the future, a buy-sell agreement is created.

A properly drafted and funded buy-sell agreement is an essential tool to enhance the stability and value of a family-owned business. It can

- provide departing owners with a market and price for an asset that otherwise might be hard to sell
- permit remaining owners to prevent an unqualified or disruptive individual from acquiring an interest in the business
- minimize business disruptions resulting from disagreements among owners or family
- provide assurance to employees, customers, suppliers, and creditors that the business will remain through owner transaction
- assure that the family-owned business remains in the family

While the structure of a family-owned buy-sell may be straightforward, how it fits into an exit plan can vary depending on planning goals. For example, in many cases control is an issue when the older generation is selling to the younger generation. The parents may want to start divesting of the business to the children, especially in order to have the children start acting as owners instead of heirs. The parents, however, don't want to give up control. To manage this common issue, the exit plan could be designed to recapitalize the stock so that there are both voting and nonvoting shares. The buy-sell agreement would then be structured to have the younger generation start to purchase the nonvoting shares currently. The agreement would provide that the voting shares, which represent control, would only be purchased (or inherited) at the death of the parents.

Capital Transfer

A common business continuity objective is to have the business pass within the family in the most efficient manner possible while assuring the retiring owner remains financially secure. In many cases, neither a sale nor a gift is the driving force in this transfer. Rather, an appropriate amount of retirement capital is transferred out of the business using other techniques. "Capital transfer" is an all-encompassing term to describe situations where capital of the family-owned business is drawn down to the owner without the owner necessarily sacrificing ownership or control of the company. A simple demonstration of this technique would be a qualified defined-benefit plan. The owner, presumably older and higher paid, would initiate a defined-benefit plan wherein he or she is receiving a large portion of the qualified plan contribution. This tax-deductible contribution effectively serves as a transfer of a potentially substantial amount of the company's equity to the owner. The remaining value can then be transferred or sold to family members at a discounted value. To the extent a qualified defined-benefit plan doesn't transfer enough capital, a nonqualified deferred-compensation plan for the exiting owner will help serve as an additional capital transfer. When the owner exits, the company pays tax-deductible deferred-compensation to the owner. Being a deductible pretax expense instead of a posttax capital transaction helps the succeeding owners to better cash flow the exit of the previous owner.

A different example of a capital transfer would be the strategy of children forming a business that subcontracts with the business owned by the parents. Over time, the parents' company would shift more of the profitable activities to the children's company, gradually shrinking their own company. With this strategy, the parents can shift significant value to the children outside the transfer tax system.

Gift

In many cases, the family transfer plan is simply to have the children inherit the business when the parent dies. This simple but unstructured plan can be as much the problem as the solution. First, it invariably leads to conflicts within the family if some of the children are involved in the business and some aren't. Further, if the owner's estate is large enough to be within federal estate tax range, this approach risks a high valuation of the business by the IRS.[13] In contrast, a carefully structured lifetime gifting plan for the business can yield results that are highly effective from both a business and a tax standpoint. In an economic environment when business valuations are currently low, use of the annual and lifetime gift tax exclusions can be particularly effective. Without necessarily giving up control of the business, the owner can design an exit plan that enables continued ownership and operation of the business by the family.

A lifetime gifting program of the family business can come in many shapes and sizes. Some programs may be as simple as valuing the business and gifting shares in an ordered manner during lifetime. Others, such as the net interest gift discussed above, may be far more complex. In the current low-interest-rate environment, it is advisable to consider gifting techniques that leverage the higher yield of the business asset against the low tables mandated for valuation purposes.

For example, GRATs are complex but, with an appreciating business, they can convert large transfer taxes into no transfer taxes. Where the effective return on the business asset is significantly higher than the § 7520 rate, GRATs are particularly powerful.[14] The owner can gift discounted shares in the family business to a GRAT, calculating the annuity back at such a rate as to make the gift very close to zero for gift tax purposes. The resulting appreciation above the government rate would go entirely to the heirs, without any gift or estate tax being imposed.

In assessing the appropriate exit strategy for the owner seeking to transfer a family-owned business, there may well be a combination of buy-sell, capital transfer, and gift techniques. The advisor's goal should not be to find the one, perfect strategy; rather, the goal is to choose among various techniques, the combination of which best accomplishes the client's intent.

Figure 2 summarizes both objectives that should be considered and the overall techniques that could be utilized in an exit plan for a family-owned business. With these two overall considerations, it becomes easier to sort through the myriad ways an exit plan can be designed and executed. The next step is to determine how to fund the transfer plan. Funding assures that the plan moves from paper to reality.

Step 3: Funding the Transfer Plan

The successful family transfer plan involves a survival plan for both the owner and the business, plus a structured exit plan for the owner. None of this can be accomplished unless the third strategy is accomplished: funding the plan. The advisor team must consider the myriad funding challenges and the many solutions available. Key in this consideration is anticipating the events that require funding. In many cases, the funding is needed at a target date: retirement, sale, etc. But other funding scenarios must be based on contingent events that have no specific date: death, disability, divorce.

The funding plan for a business transfer must be both flexible and multilayered. This assures that the funding plan can execute whether the trigger is attainment of a target date (e.g., retirement) or occurrence of an unplanned event (e.g., premature death). For family businesses, the funding challenge is compounded by the fact that there is rarely a liquidity event that generates funding. Examples of liquidity events are sale of the business to an outside party for cash or investment of outside capital through an IPO.

Because the business is to be retained by the family, outside capital does not appear when the business owner departs. Consequently, funding must usually be obtained through noncapital-based methods. The source of funding can vary. Certainly life and disability insurance are key funding vehicles for business transfers triggered by events. Additionally, lender financing can play a role in planned transfers. The children may use bank financing to buy out the parents; the estate may borrow from the government to pay estate taxes attributable to the business.

Finally, tax strategies will play a role in the funding plan. Particularly when a significant part of the transfer plan involves capital transfers to the owner, timing of tax events can help generate the needed cash flows. As discussed above, if part of the owner's equity is to be realized in the form of deferred-compensation payments, the tax deduction generated to the company helps make this plan manageable for the company.

A funding methodology should factor in all these considerations and opportunities. Several steps can help quantify the consideration process.

Funding Events

First, the funding plan should determine the dates and events where funding may be required. Beyond the date of a planned sale, events such as death, disability, divorce, retirement, and other family contingencies must also be planned for. An occurrence that business owners often ignore is the possibility that family members, especially children, may wish to leave the business. Likewise, parents must factor in the entrance of a new family member through marriage of one of their children.

Opportunity Review

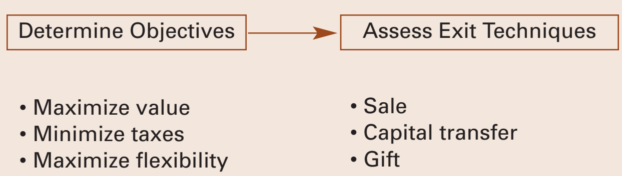
Next, the various funding opportunities should be reviewed and ranked. As stated, the object should not be to select the perfect plan, but rather to select the correct mix of funding options to meet the objectives of the family and the business. The company and family should consider their cash flows, their credit worthiness, and the effect on the business that may be caused by the owner's exit from the business. An important element of this process is to assess the timing and variability of any funding plan. Also, the opportunity review should include back-up funding plans. For example, although use of IRC 6166 to finance the payment of federal estate tax should not be considered a primary funding technique, it can be included in the list of back-up options available in the funding plan.[15]

Prefunding

To the extent possible, the plan should seek to prefund the family business transfer as much as possible. With methods like sinking funds and life insurance, the family and business can, in advance, fund the transfer plan over a period of years and have money to cover the

FIGURE 2

Step 2: Exit Plan for Owner



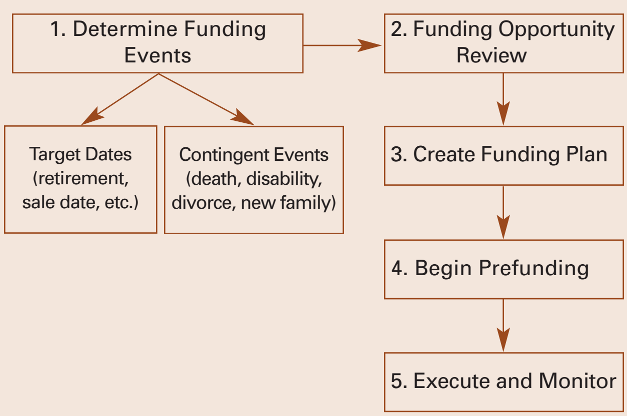
various contingencies that could cause the need for a transfer. Additionally, prefunding takes much of the risk out of the funding decision. For example, if part of the funding plan involves borrowing, contingencies must be made for a possible spike in interest rates or even lack of financing availability. Further, lack of prefunding can cause problems in cash flow management. When the company is most vulnerable due to the death or retirement of a founder, cash demands for the transfer plan can threaten the business's survival. To the extent the cash flows for these methods can be managed by the company and buyers in advance, it takes much of the risk out of the funding plan.

Execution and Monitoring

The plan must be executed. Valuations should be completed, legal documents drafted and signed, and financing agreements put in place. Any prefunding should begin as soon as possible. Insurability can change; investment opportunities can disappear. The execution of the plan should likewise factor in the effect and timing of tax events. Will the payments be deductible currently in the form of qualified plan contributions, or will they be deductible in the future when the plan pays out? Further, the plan must be monitored on an ongoing basis. Tax strategies and tax rates may change. Interest rates may rise or fall. Business requirements or changes in family composition may necessitate new strategies. The process of execution and monitoring must be flexible and ongoing. Figure 3 summarizes the steps to be taken in funding the transfer plan.

FIGURE 3

Step 3: Funding Transfer Plan



Conclusion

Preparing, funding, and maintaining a family business continuation plan do not come free, and the family business must understand and accept this ongoing expense. Business owners spend a lifetime working in their businesses yet sometimes are unwilling to take time to work on their business. A way to assure the financing for the plan is to commit some of the company's and family's wealth to devising and executing the transfer plan. Noted buy-sell expert Chris Mercer refers to this as the "1% Solution."[16] The concept is that the management fee for a typical managed investment portfolio might be approximately 1%. Shouldn't the business owner devote a similar amount to the business and dedicate a percentage of the company's wealth to pay for a valuation and the creation of transfer documents, as well as obtain adequate prefunding?

Different from many forms of financial and business planning, the planning for the transfer of a family business involves a broad array of considerations. Following a methodology helps the advisor focus on outcomes and provides a way to monitor the plan. Additionally, following a methodology helps the family understand their options and thereby leads to a better plan. ■

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(1) The Zildjian Cymbal Co. of Norwood, MA, was founded in 1623 in Constantinople and moved with the family to the United States in 1929. *Family Business Magazine* (Summer 2008).

(2) "American Family Business Survey" (Raymond Institute/MassMutual, 2003).

(3) John H. Brown, *How to Run Your Business So You Can Leave It in Style* (Golden, CO: Business Enterprise Press, 2002): 3.

(4) IRC §§ 2701-2704 and extensive regulations thereunder provide the rules for valuation of a closely held business interest for federal estate tax purposes. See also Rev. Rul. 59-60, 1959-1 CB 237 and Rev. Rul. 93-12, 1993-1 C.B. 202.

(5) IRC § 2032A provides special, i.e. lower, valuation for federal estate tax purposes of certain closely held businesses, such as farms.

(6) IRC § 6166 provides that the portion of federal estate taxes attributable to the decedent's interest in a closely held business can, under certain circumstances, be deferred for a period of years and then paid in annual installments.

(7) IRC § 303 provides that, under stipulated conditions, a corporation can redeem part of a deceased shareholder's shares without the redemption being treated as a dividend.

(8) Steve Parrish, "Taking It With You," *Private Wealth* (August, 2008).

(9) Thomas W. Deans, *Every Family's Business,* Preface at iv, (Orangeville, Ontario, CAN: Détente Financial Press, 2008).

(10) Robert C. Gellman, "Planning Your Exit Strategy: Seven Keys to Unlocking the Doors to Your Dreams," *BIZ Growth Strategies,* Wealth Management (CBIZ, July 2006); http://www.cbiz.com/article.asp?id=5.

(11) David A. Handler, "The Net Gift Strategy; Good for a Bear Market," *Trusts & Estates* (December 2008).

(12) "37.4% have buy-sell agreements or other arrangements defining who can own stock and how it is transferred." American Family Business Survey (Mass Mutual, Kennesaw State University, Family Firm Institute, 2007).

(13) *Ibid.,* endnote 4. A valid buy-sell agreement that states a price and follows the general requirements of IRC § 2703 may be able to secure a lower valuation of the business interest for federal estate tax purposes than if the interest is valued at death without reference to an agreement.

(14) The § 7520 rate is the monthly rate used by the IRS for valuing GRATs. The April 2009 § 7520 rate was 2.6%

(15) *Ibid.,* endnote 6. While IRC § 6166 is generally not recommended as a planning tool, it can still be considered postmortem as a possible financing opportunity.

(16) Z. Christopher Mercer, *The One Percent Solution* (Brockton, MA: Peabody Publishing, 2007).