PNC CENTER FOR FINANCIAL INSIGHT

The PNC Center for Financial Insight℠ builds bridges from thought to action, creating practical, applicable strategies to help benefit you and your family.

Lowering the Hurdles to a Successful Family Business Transfer

Transitioning a family-owned business to the next generation presents a number of unique financial and family dynamic hurdles, but it also presents amazing opportunities to contribute to your family's success for generations to come.

According to an international survey[1], 72% of family business owners stated that they intended to pass on ownership to the next generation, yet only 16% have a robust and documented succession plan in place. There are challenges in completing a successful transition of ownership to the next generation, but as inspirational writer William Arthur Ward once stated, "The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." In the following, we will discuss a number of common challenges to a successful family business transition and briefly introduce strategies for "adjusting the sails" to navigate these sometimes treacherous waters.

The Next-Gen Is Not Able to Purchase the Business

Funding challenges can put a hard stop to successfully transitioning a business from one generation to the next. Below, we review a number of possible solutions.

Leveraged Buy-Out

A leveraged buy-out involves the next generation borrowing funds to acquire the business. Business assets are used as collateral and business profits are used to make loan payments when due. This may be a good alternative when interest rates are low and the business has a consistent history of generating income; however, this strategy can create risk for the next generation. In a highly disruptive environment, when businesses can seemingly become obsolete overnight, the next generation may find themselves in debt without the business income to pay off the debt.

Installment Sale

The sale of the business may be structured as an installment sale with payments made over a term of years with interest. Business profits are used to make payments on the note. The terms of the note may be more favorable to the buyer than in a leveraged buy-out, in that it will likely have a longer term and a lower interest rate. The primary risk in this strategy lies with the older generation selling the business, in that they will have a longer time horizon before realizing a full liquidity event. If the business were to fail or underperform, they would either not

[1] PwC, Up close and professional: the family factor—Global Family Business Survey, 2014, https://www.pwc.com/gx/en/services/family-business/family-business-survey.html.

Contributing Author:

David Foster, ChFC®, CAP®, FLMI
Senior Resident, PNC Center for Financial Insight℠

get paid in full, or might need to take legal action against the next generation for monies owed on the note.

Self-Cancelling Installment Note

One unique version of the installment sale is the self-cancelling installment note (SCIN). When a SCIN is in place, the note terminates upon the death of the seller, regardless of whether the note has been paid in full. The buyer agrees to pay a premium for the business in the form of a higher sale price or a higher interest rate on the note. One of the advantages of this structure for the seller is that any remaining balance will be excluded from the seller's gross estate for estate tax purposes. The advantage for the buyer is contingent on the seller passing away prior to their life expectancy.

Non-Qualified Deferred Compensation

The business can enter into a non-qualified deferred compensation agreement with the business owner. This is an enforceable promise by the business to pay a certain amount of compensation to the business owner after retirement. This obligation adds a liability to the books which in turn lowers the value of the business. This creates a tax advantage to the business as the deferred compensation payments are deductible, while the installment sale payments are not. The advantage for the buyer is a disadvantage for the seller, since the deferred compensation is taxed as ordinary income while the sales proceeds are taxed at lower capital gains tax rates.

Charitable Bailout

Instead of selling the business interest directly to the next generation, the ownership interest can be contributed to a specially designed charitable trust that provides income to the donor and a remainder interest to a named charitable organization. The next generation then purchases the interest from the trust (there can be no preexisting obligation to do so). This will provide the business owner/donor with an income stream, a charitable income tax deduction, and a deferral of the capital gain. This strategy is not available to Subchapter S corporations and is most appropriate for those who need the income for a period of time, or for life, and have a charitable intent.

Sale to an Intentionally Defective Trust

Instead of selling the business directly to children, all or a portion of it may be sold to a trust with the children named as beneficiaries. This trust is intentionally drafted to make the grantor (that is, the parent/business owner) responsible for paying taxes on income generated inside the trust. The tax payments made by the grantor financially benefit the trust, and therefore the children, but are not considered gifts for purposes of the federal gift tax. Through careful drafting, it may be possible to toggle on and off this responsibility so at some future point

Common Hurdles to a Successful Family Business Transition

Each of the following hurdles may be overcome with strategies specifically designed for your business:

- The next generation is not financially able to purchase the business
- Family discord
- Key employee discontent
- Failing to plan for contingencies
- Pace of change and technological advances in business
- Federal gift taxes

the children may be responsible for paying the taxes.

Family Dynamics

There are a number of potential issues which may arise when multiple children are involved as owners. It is often this family discord that causes the transition to fail.

When children have different skill sets and leadership abilities

Depending on the nature of the business and the particular skill sets of the children, avoiding conflict may involve reorganizing the business and having different children run separate operations, acting as their own profit centers. If they fought over who got the front seat and who ate the last cookie when they were kids, it may not be a good idea to give them both equal ownership in the same business.

When there are children involved in the business and some that are not

In our experience, it is generally better to avoid giving an ownership interest to children who are not actively participating in the business. A best practice is to equalize the other children with other assets. Parents may want to provide equal ownership to all their children, but the potential for conflict is substantial. For example, if there is a year when the business needs to retain profits in order to pursue a business opportunity, the children who do not participate in the business, but have grown accustomed to receiving dividends, may be at odds with their siblings over the decision.

Key Employee Discontent

A key element of a smooth transition will be the retention and continued dedication of key employees. Bringing family members on as owners has the potential to cause discord with these key employees. One of the last things a business needs at this pivotal moment is a key employee quitting, taking the company's trade secrets, and starting a competing business. It would be prudent to consider having employees sign a proprietary information agreement to protect the business. This would also be a good time to consider ways to create incentives for key employees to remain with the business. Granting stock or stock options has the potential to cause more problems than it solves. Most states have laws that grant substantial rights to minority shareholders, and a disgruntled employee empowered with such rights may cause significant damage to a business. An alternative would be to consider forms of executive compensation which provide incentives for the key employees to remain with the company without granting them an ownership interest. Examples of such strategies are outlined below.

Phantom Stock and Stock Appreciation Rights Plans

These plans provide executive compensation that is based on the value of company stock but convey no rights as a stockholder. This also provides an advantage to the new generation of owners in that it does not immediately cause a drain on cash flow.

Non-Qualified Deferred Compensation Plans

These plans provide the employee with tax-deferred future income above and beyond the amount that may be accumulated in a qualified retirement plan, such as a 401(k) plan. Including a vesting schedule will provide an incentive for the employee to remain.

Restrictive Executive Bonus Arrangements

These arrangements provide the employee with a tax-favored cash accumulating vehicle (cash value life insurance or annuity contract) to supplement their retirement assets, tied to an agreement that limits their access until some future point in time. The downside to the employee is the delay in the timing of the payments, while the advantage to the business is an immediate income tax deduction and no liability added to the financial statements.

"The pace at which technology changes is increasing exponentially and has the potential to affect every business. The ability to easily adapt will be crucial to the success of most businesses in the future."

Stay Bonus Plan

These plans provide an employee with additional compensation contingent upon remaining with the employer for a specified period of time after a triggering event such as the change in control of the business.

With each of the strategies discussed above the business owner needs to consider potential negative implications. These include strains on cash flow to meet the compensation obligations, timing of the tax deductions (current versus deferred), impact on the businesses value, and administrative burdens.

Failing to Plan for Contingencies

While it is critical to plan for a business transition, the passage of time can bring about unforeseen challenges. The first and most important step is to review any shareholder agreements, partnership agreements, and/or buy-sell agreements to determine that they contain the appropriate rights and obligations and are funded sufficiently should an unexpected event such as the death or disability of an owner occur.

Pace of Change in Business

In a recent survey[2] of business owners, 72% of respondents recognize that they will have to adapt externally and internally to exploit the full opportunities of technology and avoid being overtaken by competitors. The pace at which technology changes is increasing exponentially and has the potential to affect every business. The ability to adapt will be crucial to the success of most businesses in the future. Adaptation often requires inexpensive access to cash. Prior to transitioning a business to the next generation, we think it is imperative to have a strong cash

[2] PwC, Up close and professional: the family factor—Global Family Business Survey, 2014, https://www.pwc.com/gx/en/services/family-business/family-business-survey.html.

position and/or strong financial ratios to allow for access to cash. For those business owners who intend to pass their business on to family members upon their death, life insurance can be a useful vehicle to allow a business to receive a timely inflow of cash when the transfer of ownership occurs. Life insurance policies that build internal cash values may serve a dual role by providing the next generation with cash upon the death of the current business owner as well as access to policy cash during their life.

Federal Gift Taxes

Since 1932, the federal government has levied a tax on gifts above a specified exclusion amount. The current rate in 2017 is 40%, and the exclusion amount is $5,490,000[3]. There are a number of exceptions, including the ability to make an unlimited tax-free gift to a spouse or to a charitable organization. For owners of larger businesses that are valued in excess of the prevailing exemption amount at the time, incurring such a substantial tax is not financially viable. There are a number of strategies that may be utilized to help mitigate this issue.

One strategy is to recapitalize the business into voting and non-voting shares. Non-voting shares would be gifted at a discounted valuation first, followed later by a sale or gift of the remaining voting shares. A similar strategy is available for partnerships and limited liability corporations. Similar to the above, the business can be recapitalized into voting and non-voting shares with only a few shares of voting stock. The owner would then gift the voting shares to the next generation and enter into a buy-sell agreement which requires them to purchase the business from the owner's estate upon his death. Smaller annual gifts of premium to the next generation can be leveraged so they may acquire life insurance on the parent's life, or loan the premium dollars, thereby avoiding gifting issues altogether. The death proceeds may be used to acquire the remaining non-voting shares at a discount.

Another strategy is to contribute an ownership interest in the business to a specially designed trust known as a grantor retained annuity trust (GRAT) which provides income back to the parent/owner with the next generation receiving the remaining balance after a term of years. When interest rates are low and the asset contributed is expected to have strong growth, GRATs may be effective in transferring substantial wealth without being subject to gift taxes.

Conclusion

There's nothing better than watching your children achieve success. Seeing your child score a winning goal, getting the lead in the school play, or being accepted to his dream college elicits emotions only a parent can understand. If you are a business owner and you have the desire to pass the business on to the next generation, and they have the skill and desire to take on that challenge,

[3] IRC Sec. 2010, Rev. Proc. 2016-55.

you'll want nothing more than to see them succeed. Giving up control may be a difficult process to go through, but giving your children an opportunity to take your business to the next level and achieve their own goals is something worth planning.

For more information, please contact your Hawthorn advisor.