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It's All in the Family

Transferring the Business to Your Heirs

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Introduction

Transferring a business you have built over the years to your son, daughter or other family members could be something that you have been considering for some time. After thinking about it for a while and evaluating all your other options for an exit strategy, you may have concluded that a family succession makes the most sense. You reason that leaving the business to your children presents you with the best of both worlds because it will allow you to secure your financial independence and pass on a family legacy at the same time. You dream of the day when your children will follow in your footsteps, take control and continue with the family business.

In reality, however, there are a number of surveys which show that although two-thirds of business owners wish to transfer the business to their family members, less than one third actually accomplish this objective. There are various reasons for this including the impact of taxes, the ability and commitment of the chil-

dren to run the business, and intervening family issues among others. Nevertheless, the real reason why business owners fail to transfer the business to their children is that they are not clear on how to approach the process of transitioning the business. This is particularly critical in an industry where the principal means of production involves the management of human capital.

If you are planning on transferring the business to your heirs, there are number of issues you should carefully consider, among them:

- Will this type of exit strategy create conflicts within the business or my family?
- Will I be financially secured after transferring control?
- Can the transfer be implemented in such a way that is tax efficient?
- For how long should I remain involved with the business to ensure a smooth transition?
- Are family members interested in taking

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charge?

- Can I effectively transfer my experience and skills to the next generation?

Understanding Problems and Obstacles

In the Staffing Services industry value is derived primarily from the efficient deployment and management of human capital. This intrinsic characteristic presents unique challenges because the successful operation of a business in this industry requires the development of specialized management skills ranging from project management to human relations. Consequently, the successful implementation of a family transition should be seen more as a carefully orchestrated process than a one-time event.

In addition to the inherent operational issues that may result from having family members take over who do not have the appropriate motivation, skills and experience, there are other important factors to consider in evaluating this type of exit strategy. Business owners need to carefully consider both the obstacles that stand in the way of attaining their financial objectives and a plan to overcome three common problems: taxation, family disputes and premature death.

With regard to taxes, rates can reach as high as 55 percent and above on the transfer of an ownership interest if it is conveyed to heirs by means of a sale or gift during the owner's lifetime or at death if transferred by will. Hence, the most logical strategy to deal with taxation issues is to establish the lowest defensible price for the business if it is to be transferred. This is a critical issue because few family businesses can withstand large tax drains on their cash flows. The objective then is to plan and implement various valuation minimization techniques, such as optimizing the owner/seller's pre and post transaction compensation, which will lessen the immediate tax impact on the value of the ownership interest to be transferred and allow greater cash flow to the seller/owner.

Another common problem in family successions is figuring out a way to transfer the business

when not all the children are active in it. While given equal amounts of the business to each child may seem to be the most logical solution, this approach can potentially lead not only heated family disputes, but also to the deterioration of the business' performance. As a result, deciding how to allocate the business to your children is an issue that requires careful planning and consideration. Among the many different options available to the business owner, one alternative would be to pass both operational as well as ownership control to the active child while making sure that the non-active children get a fair share of the estate from other estate assets. This option will avoid the situation where the non-active children end up with non-marketable interests in a business in which they are unable (or unqualified) to make decisions on issues impacting its management and future.

In the event that the family business is not transferred to other family members, or sold to outsiders for that matter, during your lifetime, you need a plan to minimize the impact of estate taxes—probably the most confiscatory tax in the U.S. tax code. It is simply amazing the number of business owners that fail to consider the possibility of a premature death given the substantial impact that such an event could have on the business, not to mention their families. Just the fact that estate taxes can run between 37 percent and 55 percent and that payment is due within nine months after death should be enough motivation for any business owner to be proactive in this area. The good news regarding estate taxes is that they can be minimized considerably if not totally avoided. According to experts in estate planning this objective can be achieved through various techniques including making full use of marital deductions and family trusts.

Achieving Financial Security

Most often the only source of cash for both the departing owner and the children is the future income stream of the business. Consequently, in designing the succession plan the business owner needs to address two key issues: (a) when to transfer full control of the business to insure that the projected income does not de-

cline, and (b) how to extract the maximum income from the business with the least tax impact.

For the most part, business owners should avoid transferring control until they are quite certain that they are giving control to the child that has both the capability and the commitment to operate the business successfully. An important consideration at this point is that the business owner should remain ready to step in and take whatever measures are necessary at the first sign that the projected earnings stream are beginning to diminish. In fact, one relatively simple mechanism available to business owners to deal with the issues of control is to form a new company owned by the children who will run it. The old company, under the control of the parents, will lease its assets to the new company. If the new company succeeds, it can eventually buy the assets from the company owned by the parents.

Dealing with the issue of extracting the most income from the business with the least tax impact requires the planning and implementation of tax minimization strategies. In essence, a tax minimization strategy involves three separate elements: (a) taking advantage of the differences in tax rates between entities and an individual or between individuals, (b) applying the maximum tax deductions available for expenses, and (c) deferring the payment of taxes for as long as possible to benefit from the use of those funds in the interim. Implementing any one of these elements can advance you toward your desired goal of attaining financial security. Implementing all three simultaneously constitutes the foundation of a sound tax minimization strategy.

Conclusion

Transferring the business to your heirs can be a positive and rewarding process for all the parties involved, if it is managed correctly. The secret to a successful family business transition is structuring a comprehensive plan for the takeover. In addition to addressing issues related to taxation and financial security, this plan should take into account non-monetary aspects such as the transitional period for the management of the business, a developmental program for the new owner, and the careful definition of the appropriate roles for the family members involved.

When there is a single heir, son or daughter, succession planning is the least complicated model,

particularly when they have the ability and interest to run the business. When there are multiple heirs, however, some experts suggest that the planning process should involve two elements: a family council, to define the responsibilities and qualifications for the successor, and an outside advisor to identify the potential successors and keep the process moving forward. Once the successor has been identified, the developmental plan will provide him or her with the knowledge, skills and experience necessary to take over and run the business.

Without a doubt, transferring a business to your heirs is a process that should not be underestimated or undertaken in haste given the significant impact it will have on the business, the family and on your financial security. It is indeed a difficult process that requires preparation and a great deal of patience, but the end results of ensuring your financial security as well as a family legacy are sure worth the effort.

