Focus

Family Affair: The Emotional Issues of Succession Planning

by Tom Nawrocki

Working with small, family-owned businesses on their succession plans can be one of the most difficult tasks for a financial advisor. Not only are the financial nuances of setting up the actual succession tricky, combining tax and estate concerns with a balance between ownership and management issues, but the advisor often must be a family therapist as well, negotiating disputes among parents and children, brothers and sisters—all while helping to keep the business alive and thriving.

Yet a financial advisor is usually the only person who can play a central role in ensuring a smooth transition.
"An objective and broadly experienced financial planner, if willing to take on the emotional issues involved, is many times the only professional who can help the family as a whole and the family members individually," says Michael McConnell, CFP®, CPA, of LarsonAllen Financial in Minneapolis, Minnesota. "It's been my experience that there is a tremendous value to everyone when an experienced financial planner works with each family member to arrive at a comprehensive succession plan. The key is being open to the feelings of each family member on a nonjudgmental basis while focusing on all the options available."

"The big areas that come up have to do with the person who's becoming the successor starting to feel like he's getting some special recognition from the family," says Dennis Jaffe, Ph.D., of Saybrook Graduate School in San Francisco, California, and the author of *Working with Family Businesses: A Guide for Professional Advisors*. "But other people want recognition, too. What's being given out in the family is esteem and respect."

And family businesses are becoming increasingly likely to be passed to the next generation. "In the small-business world, it's estimated that 35–40 percent pass on to someone in the family," says David K. Goad, ChFC, of Succession Planning Consultants in Newport Beach, California, author of the upcoming *Succession Planning Strategies for the Financial Planner* from FPA Press. "That number was quite a bit lower 10 or 15 years ago. It's changed because of the baby boom; there's more forethought being applied to this issue now."

As more and more financial advisors find themselves dealing with this issue, it's helpful to sort out the various scenarios that differentiate succession plans.

Transferring Ownership to Children

Probably the most difficult situation to deal with is one in which the owner has children, some of whom are active in the business and some of whom are not. Herbert Daroff, J.D., CFP®, of Baystate Financial Services in Boston, Massachusetts, puts it bluntly: "Treating children equally does not treat them fairly." A parent may be inclined to try to leave each of his or her children an equal amount of money or equity, but that can end up ill-serving both the family relationship and the business. "In most of the situations, the value of the business is well more than half the value of the estate," says Daroff. "Never, ever give a business half to an active child and half to an inactive child. You're guaranteeing the business will fail." Having a child own part of a business that they have no role in is worthless as far as managerial options go. Conversely, as Daroff points out, you could end up with a child who owns a third of a business seeking a third of the profits when they have done nothing to earn them, while their sibling earns the same money for devoting his or her life to the business.

This kind of trade-off cuts both ways. The sibling who is inheriting the business, under Daroff's plan, doesn't get it without the expectation of some real work. "Somewhere along the line the family has to understand that being active in the business comes with some sweat equity," he says. "Fair versus equal is what makes or breaks business-succession plans." Daroff feels the best situation is where there is a clean separation between those who are involved in the business and those who are not, urging that family-owned businesses should have only active-management stockholders.

"There's one question I love to ask owners of family businesses," says Daroff. "'Did you have a partner?'

Invariably you get a story about the partner they used to have and how horrible it was to buy them out. So then you have to ask them, 'Do you want to put your children in that position?'"

One way of dealing with that problem is offered by Dana Barfield, CFP®, CLU, ChFC, of the Barfield Group in Richardson, Texas, who is advising a Great Lakes-region manufacturing operation on its succession plans. The father, who owns the business, is trying to be equitable to his son, who is very active in the company, as well as to his five daughters, none of whom work there. While the father wants the son to end up owning the business, he wants his daughters to get a fair shake as well.

So Barfield and the business owner have begun soliciting offers from outside investors. This will accomplish two things: It will give everyone a realistic idea of what the business is worth on the open market, and it will provide a new source of ownership, if it turns out that selling is the best way to handle the transition. "If the son can't make it go," says Barfield, "the father will sell to the outside investors, so that the daughters can split the seven-and-a-half-million dollars that the business is worth."

But if the son can make the business prosper, then Barfield will have him set up an S corporation in order to buy the business in installments. That allows the son to spend less of his working capital on buying the business from his father, and reduces the tax hit the father will have to take. "The portion of the business the son doesn't have a contract for, his father still owns," Barfield says. "So the son will buy a life insurance policy on the father for the value that hasn't been sold to him yet." That way, if the father dies before the transaction is complete, the son will get enough money from the insurance policy to finish the purchase. And the father (or the father's estate, if he dies before the transaction is completed) will have enough money from the completed purchase to ensure that his daughters receive their fair share as well.

Bill Supper, CFP®, a planner with Massey Quick in Morristown, New Jersey, implemented another method of transferring ownership when a client who owned a family business was concerned about giving up too much control. "We suggested that they recapitalize the corporate stock," says Supper.Ê"This resulted in creating two separate classes of stock, voting and nonvoting. The voting shares were retained by the senior generation so that they could retain control of the business. The junior generation received nonvoting shares so they could start building equity in the business, but without management control. The added benefit of creating the nonvoting shares is that it gives further credence to taking minority discounts for transfer-tax purposes."

David Goad also recommends the self-canceling installment note as a way to reduce estate-tax liability. SCINs are essentially promissory notes that are held in exchange for the purchase of intra-family closely held business assets. These allow the second generation to make fixed, regular payments toward buying the business. If the seller dies before the purchase is complete, the note is canceled with no additional payments due to the estate, no matter how many or how few payments have been made. The seller does not escape income taxes from the sale of the business, but any unpaid balances are removed from their estate, and the buyers receive a stepped-up basis in the purchase property equal to the total of the principal payments they made.

Never Too Soon

The S corp, recapitalization of stock, and self-canceling installment note are three of the ways to tackle a vital concern to family business owners: when to start the ownership transition. Most advisors will tell you it's never too soon to start planning for that, if for no other reason than to reduce the tax liability. "I had a 65-year-old man walk into my office who owned a third of his family's company, and his 95-year-old father owned the other two-thirds," says Daroff. "Thirty years ago the business was worth 30 times less than it is today. Every day, he's been working as hard as he can to increase the estate taxes he's going to have to pay." Of course, if the estate tax is eliminated, transition of family businesses will become immeasurably easier.

Ownership issues become easier when all the children are involved in the business, but that can cloud the management issues. Dennis Jaffe has been working with a business in which the owner's daughter and son were both active in the business, but she was stepping up and learning, impressing all the people she was working with, while her brother was widely considered flaky. The father decided to install his daughter as the new CEO, which was understandable to everyone but the son. "He expected that he and her sister would share the role," says Jaffe. "So we tried to buy him out, but he didn't want to accept the buyout—he felt like he was losing the business and didn't want to do it."

One thing most experts agree on is that the concerns of the business must come before the desires of the

family. "You can't feel like the business is something you deserve," says Jaffe. "It's something you earn." He suggests that the family develop a written statement clearly outlining that the needs of the business will take precedence. McConnell agrees, pointing out, "It is very difficult to maximize the financial value while considering each individual's goals."

"The fail rate for business succession is about the same as the fail rate for second-generation client relationships," notes Paula DeVos, CFP®, of Synergist Wealth Advisors in Carmel, California. "That's a clear sign that a paradigm shift is in order. We need to incorporate 'family success' into our relationships with clients, for both their success and ours."

Management Versus Ownership

Arranging for succession as early as possible not only can help smooth over bad feelings (or at least give the children more time to get over them), it also allows the business owner more time to develop and execute the right plan. The orderly transfer of a million-dollar business ordinarily takes years to be executed properly. "A lot of owners of family-owned businesses get caught short on time," says Goad, who recommends that owners have a plan ready to go at a minimum of five years and as many as ten years from when they plan to make the transition. "You can't just hand the keys over," he says.

Jaffe often suggests bringing in a bridge manager if the older generation is ready to retire but the younger generation is still in their twenties, clearly not ready to run a business yet not old enough that the possibility can be ruled out. "Hire a bridge manager for seven years to develop the business and the brand, and to train the next generation to help them figure out who the next leader would be," says Jaffe.

Again, letting the second generation know of such plans early on is paramount to avoiding hurt feelings. "You need to let them know early that they can work here, and they can have a career, but they may not be the president," says Jaffe. "The best person is going to be the CEO, not necessarily a family member."

Jaffe has found that most children understand the situation when it's presented to them in this way. It's being led to believe they will play a key role in the company and having those dreams dashed that leads to serious problems later on. "The betrayal adds the great negativity—not the fact that you've made a deal with an outsider," Jaffe says.

Another reason to consider outside management, says Goad, is that family business owners don't always hold the next generation to the same standards that they would an outsider, or even a longtime employee. "The owner has to set aside the emotional issues of having a son or daughter involved in the business and make sure the business is still run professionally," he says. "The way around that is to bring in outside management."

If the older generation intends to pass management on to their children, they should be involved in running the company as early as possible. "If the younger generation has been very visible, clients may not even know that a transfer has taken place," says Goad. "It's far less disrupting than other situations."

Some planners argue that management issues are more important than ownership issues. After all, anyone can own the business, but its continued health and value rely on the quality of the management team. Succession plans suffer when they focus on ownership at the expense of who's actually running the company. "Key employees are loyal to the owner, not the business," says Daroff. "If Dad wants them to be there, then Dad needs to set up incentives for them to think like an owner. And he needs to tell them, 'Here's the plan for succession, and here's what we'll do for you as part of the management continuation plan.'"

"The primary issues are who's competent to be leading the business to the next level," says Dennis Jaffe. "Sometimes the business needs to get a nonfamily leader to bring in another kind of leadership." If that's the case, then communication again is the key. Family members must be told clearly that the business will come first, before consideration of anyone's feelings. "Does the next generation know that the business is run on business and not family principles?" Jaffe asks. "It's got to be made clear to them when they enter the business, or even before."

Communication

Increasing that communication often falls to the financial advisor, who sometimes must play therapist in addition to managing the financial side of things. Paula DeVos recommends holding regular family

meetings to address the business issues. "The same tools and techniques for success in business planning are strong, open mutual communication, strong trusted relationships both in and out of the family, and a strong, planned strategy that is executed," she says. "Getting the first generation on board is often the most difficult task as the independence, drive, and sheer perseverance that allow success do not always translate well into the team approach that a succession plan requires."

There is no magic pill for solving succession problems that will satisfy the needs of the business as well as each of the family members involved. "It is very difficult to maximize the financial value while considering each individual's goals," says Michael McConnell. What the experts agree on is that an advisor needs to consider a wide range of options for a successful transition, then announce and implement a plan as early as possible. Succession is not a single event, but a series of strategies implemented over a long period of time—in most cases, the longer the time, the better. "With more pre-planning, small-business owners can look at a lot of different strategies in advance," says David Goad. "With planning, passing the business along to a family member is better in every way."

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Sidebars:

The Ever-Changing Estate Tax

In the past, advisors turned to the qualified family-owned-business deduction (QFOB), which allowed for up to $1.3 million to be excluded from an estate if the decedent was passing on a family business. The QFOB was rendered irrelevant in 2004 by increases in the estate tax exemption, which has now surpassed that $1.3 million. Advisors are now using self-canceling installment notes, re-capitalization of the voting stock, or other forms of segmented sales to gradually transfer a business from one generation to the next. If the estate tax is fully repealed, expect other estate-planning tools to go by the wayside as well.

Succession Planning Guidelines

- It's never too early to start planning for a transition
- Let the next generation know early on what the plan is
- The concerns of the business must come before the desires of the family
- Hold family members to the same standards as outsiders
- Consider a bridge manager if the next generation isn't ready
- Treating children equally does not necessarily treat them fairly
- Never give a business half to an active child and half to an inactive child
- Being active in the business should earn some sweat equity
- Consider a segmented sale to ease the transition