

Succession Planning for Family Businesses

HIGHLIGHTS

- Need for planning
- General planning considerations
- Choosing a successor
- Dividing the estate fairly
- Working with advisors

In the next two decades, close to one trillion dollars of net worth in Canada, currently held by the older generation will transfer to the next generation. With a good portion of this wealth held in the assets of family-owned businesses, succession planning has become very important for all businesses that are committed to preparing for their future success. It involves a formal process of transferring the ownership and control of the business from one generation to the next.

Most family businesses rely heavily for their results on the leadership provided by the family member holding the top management position, who usually is the founder of the business. The succession plan in this context should address various contingencies including the death, disability and retirement of the business owner.

This article will focus on the general planning issues involved in the process of choosing a successor for the first generation owner and the challenge of dividing the estate amongst the heirs once the owner passes away.

Need for planning

According to a recently published survey conducted by Deloitte & Touche¹, only 40 percent of family-owned businesses in Canada have a written plan in place in the event of death. Only 30 percent of the respondents surveyed indicated that a successor for the business had been selected. A majority of respondents indicated they had not established a process for selecting a successor despite the fact over three-quarters of today's family business leaders plan to retire in the next 15 years. As noted in the survey commentary, "There is an urgency, therefore, for family businesses to put in place the planning that will secure their future."

General planning considerations

Assuming that it has been determined that the business is worth passing on, at least four

major factors need to be examined in determining whether or not it would be in the family's interest to retain the business. These factors are as follows:

- Family's share ownership** – Does the family presently own all or a majority of the shares of the corporation? If the family's interest in the corporation is a minority one, the interest of the shareholders should not, in most cases, be retained.
- Competent successor management** – Is there available competent successor management, preferably within the family, i.e., son or daughter?
- Reaction of the customers** – Will the customers accept a successor to the present majority shareholder-owner? Some incorporated businesses depend on the personality and reputation of the owner for their success. In these cases, any successor may be at a considerable disadvantage as far as the customers are concerned. If this is the case, the business might best be liquidated or sold at the death of the present owner rather than risk an almost certain failure by a successor.
- Corporate credit line** – Is the current corporate credit line dependent upon the presence of the shareholder-owner in the business.

Two other factors which impact on the decision to retain the business in the hands of the family are:

- Sufficient estate liquidity – There must be sufficient liquidity in the shareholder's estate to meet the cash needs of the estate.



¹ The First Success Readiness Survey of Canadian Family-Owned Business, 1999, Deloitte & Touche

- Sufficient estate income for the non-active spouse – The estate that exists outside the corporation should have sufficient assets to provide a comfortable income for the shareholder's surviving spouse who is not active in the management of the business and is not interested in being a shareholder in the business after the death of the spouse. A shareholder who provides a separate source of income from outside the business on this basis avoids putting the burden of supporting his or her spouse on the business. In order that enough assets are available to meet this objective, life insurance can be taken out on the business owner. This planning approach ensures adequate income will be available to the surviving spouse to maintain his or her current lifestyle and positions the business for the transfer to the next generation.

Choosing a successor

The process of choosing a successor in the case of a family-owned business is considerably different from the method generally followed for a publicly-traded company. In the latter situation, succession is generally carefully orchestrated by the board of directors who usually have the benefit of being able to draw on a large number of potential candidates, both within and outside the organization. In the case of a family-owned business, the process also needs to be well-managed so that harmony among family members and key employees is maintained and there is a general commitment to the plan.

If the owner has more than one child interested in running the business, the owner will need to decide which child is to be selected based on qualifications and proven capabilities. In the Deloitte & Touche survey, business owners ranked "commitment" and "decisiveness" as the most important attributes for a potential successor. The skill set for the job will include general management abilities, business knowledge, financial management, interpersonal skills and marketing savvy especially in customer relations.

The succession plan should include provision for the development of the skills of the selected individual so that he or she is given every

opportunity to improve and grow within the organization prior to actually moving into the business' top management role.

Dividing the estate fairly

Once business owners have decided to transfer the business to family members, the business owner must consider whether or not to split the business among all members of the family. Often the only fair solution from the business owner's perspective is to leave the business to all the children regardless of their current involvement in the business operations. This approach may provide an equitable distribution of the estate in terms of division, but it can give rise to conflicts among the children unless there are common objectives for the future of the business and an understanding concerning the involvement of the children in the daily affairs of the business.

In the case where there is one or more active child in the business, it is generally best to leave the shares to them while dividing the rest of the estate among the non-active children. This plan will not only prove workable if there is general agreement with everyone involved about the fairness of the distribution and only if there are sufficient other assets in the estate.

One means of ensuring that all children are given fair treatment is to provide adequate liquidity in the estate so that if the business is bequeathed to the active children, the rest of the estate will be sufficient to compensate the non-active children.

Life insurance is a common means of addressing the need for capital in the estate to meet the objectives of fairness among the children. The amount of life insurance necessary to satisfy all interests may not be easily determined since each person involved may have a different view as to what is fair.

If, for example, there are two children and the business left to the one active child is worth \$2 million, is it fair to leave non-active assets including life insurance proceeds of \$2 million when the active child will inherit all the risk and challenges of running the business?

This question should be addressed in conjunction with on-going discussions among family members to diminish the potential for conflict once the business owner passes away.

*For individual circumstances,
please consult with your tax
and legal professionals.*

Generally, life insurance will prove to be the most cost-effective means of providing sufficient liquidity to ensure a smooth succession transition. Ownership of the life insurance will vary depending on how the proceeds are to be utilized at the time of death.

Let's apply three possible solutions to the above example:

1. Have the insurance owned and paid for by the business with proceeds payable to the business as the beneficiary under the policy. In these circumstances, businesses that are private corporations are in a position to pay a tax-free capital dividend equal to the proceeds received excluding the adjusted cost basis of the policy.

In the above example, after the business owner dies, his or her estate will own the shares so the capital dividend will be received by the personal representative for the estate. In turn, this amount will facilitate a payment to the non-active child under the terms of the deceased shareholder's will with the shares of the business going to the active child. It should be kept in mind that if the business owns the life insurance, any cash value build-up in the policy could be accessible by the creditors of the business prior to the life insured's death and the life insurance proceeds could be accessible by the creditors of the business at the time of the life insured's death.

If creditor proofing is of concern in this case, the life insurance should be owned by the parent with the non-active child as the beneficiary. The premium payor could be the parent(s), or the active child, or both.

2. Bequeath the shares of the business equally to the two children on the premise that the active child would buy the shares from the non-active child. This arrangement could be covered off in a buy-sell agreement with the children. For this purpose, the active child will maintain life insurance on the founder's life and will use the insurance proceeds to buy the shares from his or her sibling.

3. An estate freeze may be a consideration if the founder has a definite intention to transfer shares to one or more family members. It sets the value of the business interest at a predetermined level with any further growth in the company's value then accruing to others.

Typically, an estate freeze can be accomplished by converting the value of the common shares into preferred shares that are redeemable in the future for a fixed value. The active children acquire the common shares at a nominal cost, so the future growth passes to them as owners of the shares. An undertaking can be made to pay the non-active child(ren) a dollar amount that equates with the value of the owner's frozen shares in today's dollars. Life insurance can be used as a means of funding the pay-out.

Working with advisors

The development of a succession plan for business owners can only be properly addressed through the collaboration of the various professional advisors for the business. This process will invariably draw upon the experience and expertise of professionals from disciplines such as law, accounting, life insurance and investments.

Succession planning as a process will vary from one case to the next depending on the unique circumstances of the business owner. Appropriate steps taken by the business owner will ensure that the family enterprise will continue to prosper in the years ahead as a source of livelihood for his or her family members.

Disclaimer:

The above should not be taken as providing legal, accounting or tax advice. You should obtain your own independent professional advice from your lawyer and/or accountant to take into account your particular circumstances.