The Exit Playbook | NAVIX Consultants

Planning to Pass Your Business to Your Family? Prepare to be Unfair

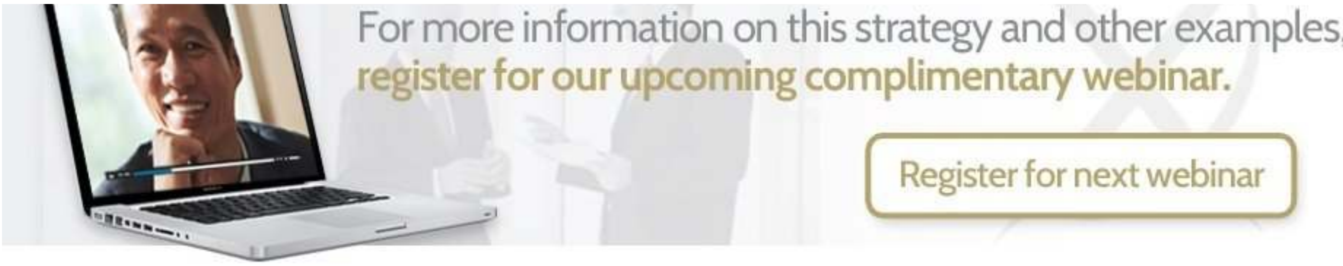
Written by Patrick Ungashick | Apr 27, 2017 6:02:44 PM

Like many parents who own a successful family business, you may be thinking of passing the business to your children. You have built a great operation, and you are proud to present this opportunity to your family.

While making the decision to keep the business within the family may be straightforward, getting that done without harming family relationships often proves more difficult. Based on the US Small Business Administration statistics, chances are that your business will not survive the second generation:

- Only 30% of family owned businesses survive to the second generation
- Only 12% are still viable into the third generation
- Only about 3% are still viable into the fourth generation

For over 25 years working with business owners, we have identified many issues that complicate efforts to pass the business to family members. We have also recognized that this is an important strategy in exit planning and here at NAVIX gave it a name. If your business exit strategy is to pass it to the family, we call this the Passer strategy.



We have also identified the challenges that are common with this exit strategy. Some of them are outlined below:

- How will you get by if all of your wealth is tied up in the business?
- How will you address income and estate taxes?
- What if not all of the children have worked and contributed to the business?
- What if not all of your children or their marriages are stable?
- What if your children are unable to currently run the business?
- How will your loyal employees react to working for your children?

Based on our experience, there are three key needs to successfully pass the business to family members. You must define success, evaluate and model different strategies, and solicit input from and communicate amongst the family.

Need One: Define Success

In defining success, it is important that you begin focused and deliberate conversations with the family, explaining your goals, and addressing common issues. The majority of parents have two common goals; treat all children fairly and make sure that everyone continues to attend Thanksgiving dinner. At the surface, these goals are relatively straightforward. However, real progress only begins by answering the foundational question of what does fair mean to your family?

Most parents' wishes are to be fair and treat all their children equally. In most cases to treat a group of people "fairly" means to treat them equally, but in this situation that will not work. Consider the following example:

A mother and father have a total net worth of $10 million, consisting of a business worth $8 million, a commercial office building rented by the business worth $1 million, and a final $1 million held in some home equity and liquid investments. These same parents also have three children, one of whom has worked in the family company for twenty years, and two of whom never worked in the company. These parents want to treat all their children fairly as they consider passing the company down to the next generation. Yet, let's consider the following:

Splitting up their total $10 million net worth into three equal portions for their children would be equal, but almost certainly not viewed as "fair" by the one child working in the company. (In our experience, likely nobody in the family would see this as "fair.")

Passing the $8 million company to the one child working there, and leaving the remaining $2 million to the other two children likely would not seem fair to some or all of the family either.

The challenge is both clear and seemingly insurmountable. For most business owners:

- Your assets are not equal. Most business owners have 85-90% of their net worth tied up in the business or business related assets.

- Your assets are not the same. Your assets fall into three categories: the business, real estate, and liquid investments. The business is illiquid and provides income.
- Real estate is illiquid and generally doesn't provide proportional income. Liquid investments convert easily to cash, but are generally a small percentage of their net worth.
- Your children's contributions to the business are not equal. Based on the data from our Passer clients, we found that all of them had multiple children, but none of them had all of their children working in the business.
- Your children are not the same. Some children may be successful on their own accord while others require more support or have less income-earning capabilities.
- Parents can better understand what fair means to them when they have considered the following questions:
- Should sweat equity be considered for those that worked in the business?
- How will they balance the disposition of their assets based upon their value, income producing potential, and liquidity?
- How will you balance the disposition of your assets based upon your children's needs and abilities?

Once these questions (and other questions) are answered and success is defined, strategies can be evaluated and modeled.

Need Two: Evaluation and Model Strategies

Exploring strategies is equal parts gathering data, evaluating the pros and cons of different tactics, and modeling the financial impact of the various approaches to parents, the business, and children.

Initially, Parents should calculate their Exit Magic Number™ (which indicates their financial dependency upon the business). This exercise helps illustrate the transition from earned income to passive income.

When building financial models it is imperative to explore exactly how the assets will be split amongst heirs. It is important to factor in all assets and whether they are business or personal, liquid and illiquid as they all involve different considerations. This step can only be done after the question of fair and equal had been addressed.

Perhaps the most important consideration in building models is to incorporate tax minimization strategies to lower the overall taxation on wealth transfer. In any Passer strategy there are four parties involved: the parents, the children, the business, and the Internal Revenue Service. We need to make sure the first three groups are on sound financial footing following a transition. Then, we also need to minimize the taxes received by the IRS.

Need Three: Solicit Input From and Communicate Amongst the Family

While listed last in our order, our experience is that this need is the most important. Further, it must occur early and often.

During the planning process communication can occur individually and in group settings. In those early conversations, the objectives are often to address the family's and each individual's thoughts on fair and equal, sweat equity, and estate equalization. From these discussions, the group can emerge with mutual agreement on the desired outcomes.

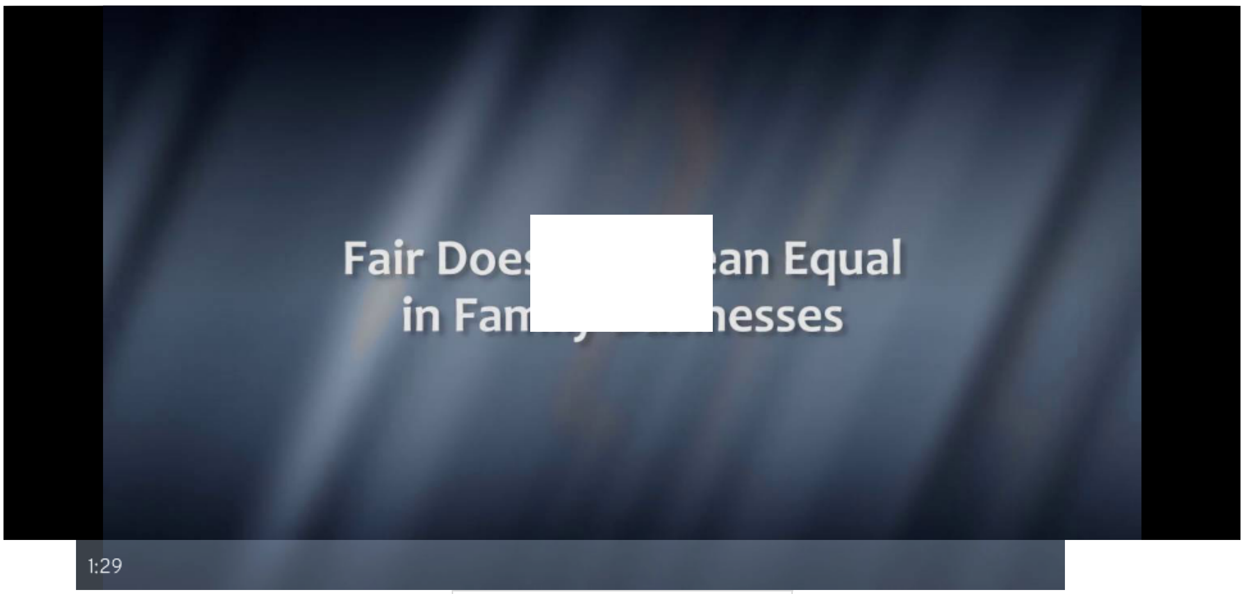
Progress and alignment often take time to emerge as family members have different understandings of financial, business, and tax matters. Additionally, history, emotions, and sibling rivalries often play a part.

For all these reasons, it is advisable to involve objective advisors who look out for the families and the businesses best interests as a whole.
The communication needs and dynamics of each family are different and hard to predict, however there are three absolutes:

- Waiting too long to plan and discuss how the business will be passed to children only makes things harder.
- Assuming children will be able to work it out amongst themselves later is problematic.
- Having the parents express their goals and allowing them to lead the process is invaluable.

The most satisfying work we do at NAVIX is to help family owned businesses pass from parents to children. While it is the most satisfying, it is not the not easiest.

To ensure contentment and continuity, it is imperative families address the three needs outlined above. This positions the parents, the business and the children for success and happiness.



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