PNC Insights
How to Transition Your Family Business to a New Generation

Overcome the obstacles you may face when transferring your family business to the next generation. Starting early is your first step!

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Oct 16 2019 | 5 min read

Learn these common hurdles and strategies to help you complete a successful transfer.

As a parent, there's nothing better than watching your children succeed, whether it's scoring a winning goal or being accepted by a college. If you're a business owner wanting to pass it on to the next generation, you'll want the same feeling. Giving them an opportunity to take your business to the next level and achieve their own goals is something worth planning for.

"A successful family business outlines the company's purpose and vision, identifies competition and finds a balance between personal and business relationships," said Karen Collingsworth-Crusse of Hawthorn, PNC Family

Wealth®, a division of PNC Bank that serves ultra-high net worth families. "Transitioning a family-owned business to the next generation presents a number of unique hurdles, including financials, but it also offers amazing opportunities to contribute to your family's success for generations to come."

Learn the common hurdles to a successful transition and how you can design a strategy to help jump them.

1. Failure to Distinguish between Ownership vs. Leadership & Management

Succession planning for ownership involves legal matters, including buy and sell agreements, whether it be selling to children, managers, employees, investment groups or an outside competitor and deciding who will own shares.

Conversely, succession planning for leadership and management refers to training the next generation in these types of roles.

"Start both types of succession planning as soon as possible because the process could take years. It is easier to transition in phases, and it builds in buffer time for unexpected changes," said Collingsworth-Crusse. "Set attainable short-term, mid-range and long-term goals."

2. Not Preparing the Next Generation

As part of succession planning for leadership and management, the older generation should teach the new to follow the same vision and business goals, while incorporating family values. Collingsworth-Crusse and Dr. Donald Levitt of Levitt Consulting, Inc. suggest creating plans and goals in these areas:

- **Strategic thinking.** Both the current and next generation should create longer-term plans, such as modernizing the business while keeping with tradition, and hiring in areas of weakness.
- **Development plans and performance evaluations.** Current owners should develop a hands-on experience and mentor the current management team. As

a check-and-balance system, try having a family member report to a non-family member.

- **Managing finances.** Current owners should make sure their successors understand everyday financial practices and how to separate personal and business expenses.
- **Education.** The next generation should complete higher education and gain experience outside of the family business to bring new skills back that the business needs.

3. Not Willing to Give up Control

Also, as part of leadership and management succession planning, the senior generation will need time to become comfortable with the transition. Tension could develop if they feel they are being pushed out. Having a clear plan for life after retirement will help to prevent the temptation to interfere.

One way the retiring generation can still contribute is by strengthening the role of the board — if applicable — to oversee the process and confirm positions are being filled properly.

4. The Next Generation Cannot Financially Purchase the Business

Part of succession planning of ownership, many business owners have the majority of their net worth invested in the business. If you can't afford to give it to the next generation, and they can't afford to purchase it, consider these options:

- **Leveraged Buy-Out.** The next generation borrows funds to buy the business. The seller receives money immediately, while the next generation uses business profits to pay the loan.
- **Installment Sale.** Payments are made over a term of years with interest. Unlike a leveraged buy-out, the seller will not receive all the money at once.

- **Self-Cancelling Installment Note (SCIN).** A version of the installment sale, the note terminates upon death of the seller, regardless of whether it has been paid in full or not.
- **Non-Qualified Deferred Compensation.** The current business owner must pay a certain amount to the seller after retirement. Although these payments are deductible for the buyer, they are taxed as ordinary income for the seller.
- **Charitable Bailout.** Ownership interest is sold to a charitable trust instead of directly to the next generation. They then purchase that interest from the trust. Not available to subchapter S corporations.
- **Sale to an Intentionally Defective Trust.** Instead of selling the business directly to children, all or a portion is sold to a trust with the children designated as beneficiaries.

These options must contain specific terms and be structured in a specific way to reach preferred tax consequences to both the seller and buyer. Consultation with professional advisors is essential to achieve desired results.

5. Family Discord

With multiple children involved as owners, family discord can cause failed transitions. Think back to when they fought over who ate the last cookie as kids.

“If there is conflict, identify what the next generation wants and values the most. Find commonalities and work from there,” said Collingsworth–Crusse. “Resolution comes from open communication and considering others’ perspectives.”

Depending on the nature of the business, when children have different skill sets and leadership abilities, avoiding conflict may involve business reorganization, which would allow different children to run separate operations acting as their own profit centers.

6. Key Employee Discontent

A vital element of a smooth transition is retention and continued dedication of key employees. Bringing family members on as owners also has the potential to cause discord.

“Many family businesses have a blend of family and non-family employees. You can’t risk a key employee walking away, taking the company’s trade secrets and starting a competing business,” said Collingsworth-Crusse.

To prevent this, identify retention and engagement plans, consider having employees sign a proprietary information agreement and create incentives for key employees to remain, including forms of executive compensation and bonuses.

7. Technology Advances

A challenge for all businesses is to adapt technologically and avoid being overtaken by competitors.

“The pace at which technology changes is increasing at a high rate, with the potential to impact every business,” said Collingsworth-Crusse. “The ability to easily adapt will be crucial to the success of most businesses in the future.”

Prior to transitioning a business to the next generation it will become even more important to have a strong cash position and/or strong financial ratios to allow for access to cash for these changes or investments in new technology.

Living out Your Succession Plan

Succession planning is an opportunity for you to plan out what you want your business to look like when you’re no longer at the helm. As always, consult with a financial advisor that can help you design and implement a strong plan.

“Succession planning is a very emotional topic and logic is often tossed out the window. It’s when families aren’t proactive that something happens, everyone scrambles and quick decisions take place,” said Collingsworth–Crusse. “We offer objectivity so you can create a succession plan that is workable and easily implemented.”

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.