Advising The Family Business

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SUCCESSION PLANNING FOR UK FAMILY BUSINESSES
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"Clogs to Clogs in Three Generations?"

1. Key Issues

- What is a 'Family Business'?
- The four "C's" – Continuity, Command, Community and Connections
- Why do so few Family Businesses make it through successive generations?
- Overlapping 'Family', 'Ownership' and 'Business' issues
- Conflicts arising between Family members, Shareholders and Business managers
- Why should we as professional advisers focus on these issues?
- Trends influencing strategic decisions in relation to UK Family Businesses
- Control and the financial consequences of ownership
- Succession Planning
- Obstacles to passing on the Family Business:
    - Legal constraints (if any)
    - Family issues (choosing the right successor)
    - Taxes (on gift or on death)
    - Divorce considerations (a growing concern)
- How careful planning and holistic advice can help

1. Background

Despite significant revenues of large quoted corporations, the backbone of the world economy is the small or mid-sized business – many family owned (thought to be around 64% in the UK). A 'Family Business' is generally regarded as one controlled (ie 50%+) by the family where there is (or an intention for) more than one family generation involved in management. In Germany, family businesses account for 60% of all companies and generate 55% of German GDP. In Spain, family businesses provide 80% of all private employment. However, the same research published in *Family Business Review – September 2005*, the *Journal of the Family Firm Institute*, indicates that in Germany and Spain "less than 15% of family-owned businesses reach the third generation".

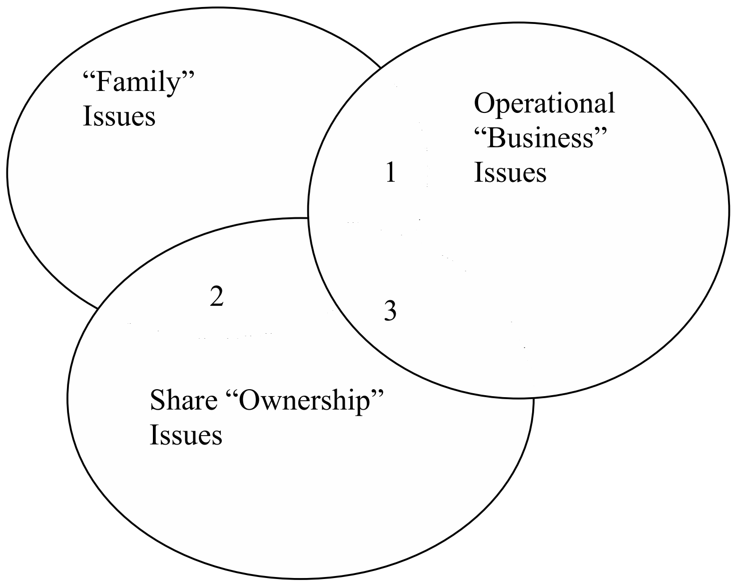
In the UK there are good commercial and tax reasons why this may be so. However, there is a concern that some Family Businesses stop growing or decline simply due to inherent difficulties that arise within the Family Business model. With foresight and planning, these potential conflicts could be avoided.

Entrepreneurs are increasingly mobile and the economies of Eastern Europe and Asia are creating businesses operating across the world – trading in the UK or looking to London capital markets for financing (private or institutional), for example. The traditional UK Family Business model will evolve to take into account these wider influences – both cultural and legal. UK Family Business advisers need to understand not only those issues relevant under local UK law but also relevant laws in other jurisdictions – *sharia law* principles being an example in one client case where a business is owned jointly by Egyptian and UK shareholders.

In the UK, most large or medium sized businesses are incorporated as private limited liability companies (with "Ltd" after their name). Some companies, normally quoted, are public limited companies ("Plc"). Some very successful businesses operate as partnerships (limited or unlimited liability). Here, we deal mainly with private limited companies.

3. Key issues for the UK family business

Togury and Davies promoted the notion of the family business involving three dimensions illustrated below, creating points of potential conflict at the overlap points 1, 2, 3 and 4 in particular.



The three circles highlight how there may be, amongst other possibilities:

- family members who are also shareholders;
- family members who are involved in management of the business; and
- family members who are shareholders **and** managers, for example.

As a business develops and shareholdings fragment, the complexity of these "overlapping" responsibilities and potential for conflict increases. In short, it is easier for a single founder shareholder who is also the chief executive to steer the business on course than it is for his 10 grandchildren and a larger management team with its own shareholding.

Professional advisers in the Family Business environment need to deal with a combination of:

- Shareholder planning and control issues (including succession planning and tax advisory work for the shareholders in particular but also constitutional and corporate governance advice);
- Operational business advisory (including general commercial, legal, accountancy and business and management consultancy advice); and

- Increasingly, perhaps, emotional and behavioural issues affecting the family members themselves (organisations such as the *Family Firm Institute* founded in the US, focus heavily on this area).

These require the skill of more than any one professional qualification. Few professional firms (and fewer advisers!) will seek to cover all three dimensions. Most will specialise in just one area although they should have a good knowledge of "the bigger picture".

4. UK Family Business trends

The following key UK trends can be noted:

4.1. **Increasing internationalism** can be seen not only in the operational activities of the companies themselves but also in the number of UK businesses owned by non-UK domiciliaries. Non-UK domiciliaries, even if resident in the UK, benefit from a favoured UK taxation status in respect of assets or investments held offshore (including through offshore trust structures). Accordingly, it is not unusual to be dealing with foreign cultural and legal succession issues. Often as a means of side-stepping these succession systems and taking advantage of the UK tax system, shares are gifted into offshore trusts managed from the Channel Islands, the Caribbean or elsewhere subject to the laws of those jurisdictions.

4.2. **Increased levels of employee share participation** in businesses (quoted as well as family businesses). As managers expectations increase, the level of management share participation can only move higher in years to come. This raises particular points of conflict in relation to longer-term business goals with management more likely to seek an earlier cash exit tied in with their own retirement as opposed to the founder's wish for longer-term family succession. What value does one place on management shares? How can businesses raise liquidity to buy back those management shares?

4.3 **Increasing access to institutional money** either through venture capital, ability to list on the smaller UK Ofex or AIM markets or NASDAQ (or its subsidiary) markets as a means of achieving a cash exit in all or part of a business or as a means of attracting additional capital to finance operational growth. This can be raise funding, for example, also to provide liquidity for a sibling who is not intended to succeed to the business. A recent study by the *European Private Equity & Venture Capital Association* identified that one third of MBO's and MBI's between 1994 –2003 were effected to help achieve generation transfers / succession planning.

4.4 **Tax Incentives for Businesses**

Whilst the current UK corporate tax environment is looking less competitive now compared to some of the new EU member states low levels of taxation, favoured tax rates for non-UK domiciliaries and for individuals holding shares in private trading companies make the UK Family Business an attractive investment for UK residents:

4.4.1 Share incentive and share option schemes have been promoted by the UK Revenue to expand wider share ownership. Perhaps the most beneficial, known as "Employee Management Incentives" allow share options in qualifying trading companies to be awarded tax free on grant and subject to capital gains tax of just 10%, effectively, on any realised gain 2 years later.

However, options must be exercised within a maximum of 10 years and once exercised "free" options will generate some income tax liability and accordingly managers will be looking for a "cash" exit as soon as possible.

4.4.2 Personal capital gains tax on sales of business assets by family members (after a two year holding period) would equate to just 10% for a higher rate tax payer or just 5% for a basic rate tax payer. A zero tax sale can be achieved in respect of recently inherited shares which have benefited from a "tax free" uplift on the death of, say, the business founder.

4.4.3 For inheritance tax/death duty purposes, businesses can be completely exempt from inheritance tax after two years of ownership (in respect of the "trading" value rather than the pure investment value of a business).

4.5. Finally, one can see how the greater freedoms associated with modern living are likely to result in a larger number of family members seeking to make their way independently and outside the Family Business environment - and an increasing acceptance by the older generation that this might happen.

In short, these factors help explain why multi-generation family owned businesses are becoming rarer. As advisers, our role is to help put in place structures which allow those families to thrive in what is today a highly complex and competitive market place. Alternatively (or simultaneously) we must recognise the likelihood of a sale, MBO, IPO or merger of the family business in future years and help to ensure that the business and the family's tax planning is in good shape to maximise opportunities and avoid foreseeable problems. In practice, an exit may often take place within a few years of the founder or key manager's death or retirement.

These issues are complex but they present a fascinating challenges for professional advisers.

5. Succession Issues for the Family Business

5.1 For the Family Business wishing to remain successfully family owned, the publication "*Managing for the Long Run: Lessons in Competitive Advantage from Great Family Businesses" (Harvard Business School Press 2005)* refers to the principles of the four "C's" as being a key factor in achieving success and longevity:

- Continuity: the desire to build and maintain the business.
- Command: the belief and desire to retain control within the family
- Community and Connection: the desire and ability to form and retain enduring relationships with employees, customers and external stakeholders perhaps at the expense of the controlling family.

5.2 For those Family Businesses wishing to stay the course, there remain numerous challenges to effective succession planning through the generations:

5.2.1 **Legal Restrictions**: Forced heirship rules applicable in certain jurisdictions have cross-border application although not applicable to UK domiciliaries in respect of UK assets. The application of forced heirship rules may lead to fragmentation of shareholder control and loss of direction within the business. If freedom of testamentary disposition is not embraced under a UK Will, fragmentation may nevertheless occur as a consequence of the statutory intestacy provisions in default. A well drafted will is likely to appoint suitable trustees to hold and manage shareholdings to achieve tax and creditor protection advantages.

Legal restrictions or pre-emption rights in Articles of Association may also have the effect of creating restrictions on devolution – for example rights for a surviving partner to buy-out a deceased business partner whether or not the family of the survivor is as well suited to managing the business going forward.

5.2.2 **Taxation:** As referred to above, with 100% relief from inheritance and a tax free 'uplift' on death being available on death on a person's shareholding, a founder shareholder may be tempted to retain shares until death albeit this may not be in the best interests of the business as a whole (or the family).

By contrast, where a sale of a business is likely to occur before an elderly shareholder's death, it may be sensible for gifts to be made to the younger generation or into trust for their benefit. This is because cash sale proceeds from the share sale may otherwise be taxed at 40% inheritance tax rates. If a donor survives a gift by seven years the value of that gifted asset falls out of account for inheritance tax purposes.

For non-UK domiciliaries, again the use of an offshore holding structure can ensure that business or non-business assets remain outside the scope of UK tax altogether.

An element of informed crystal ball gazing is required to achieve the best results taking into account both changing circumstances and likely changes to the tax regime.

5.2.3 **Family**: Failing to involve the younger generation in the Family Business at an appropriate time or in an appropriate way can lead to disinterest, rivalry and hostility both within the family and from management.

The following may need to be weighed up by a family business client:

(a) Whether to sell the business to maximise its value whilst under his control (but what then to do with the sale proceeds and how will the family react to this wealth?)

(b) Whether to choose one or more family successors, excluding others (if so how does one compensate those others for their omission from future business profits/ proceeds)

(c) Whether to partly dilute the family shareholding by way of MBO, private equity, IPO or leverage – hopefully in each case selecting the most suitable and ensuring that one achieves the best of (a) and (b) above rather than the worst of both worlds!

(d) Once a decision has been made, how best to implement this and inform the family and management team.

Whilst there can be no universal answer to which of (a) – (c) is best for the business and the family (each being unique!) there is widely accepted best practice for dealing with the "how" at point (d) above. This will involve taking appropriate legal, accountancy and other professional advice as well as consulting the family and management teams at some length before reaching any conclusions. Adoption of appropriate Articles, Shareholder Agreements, Service Agreements and Share Incentive plans as well as non-binding Family Charters/Constitutions are areas one might focus on. The process may take a great deal of time, skill and care.

5.2.4 **Divorce**: Divorce is an increasingly concern within the UK. Two in five marriages end in divorce and the UK Family Courts are scaling new heights in terms of awards made to non-earning spouses, especially after long marriages. The Court's declared starting point is for equality of treatment between spouses in cases where the wealth of the parties has been generated during the marriage. In practice, however, the Court will be reluctant to divide a business although each case will be assessed on its merits. The Court is less willing to make awards in respect of inherited wealth although the law in this area remains unclear since many contested 'big money' cases are settled out of Court. The Court's jurisdiction to make orders binding on the parties may extend to certain "nuptial settlements" created during the course of the marriage. For this reason, it is important for trust planning to be undertaken at the earliest date possible, well before the contemplation of marriage or a child's marriage and for the trusts not to be subsequently "tainted" by restructuring, advances out or poor administration.

In all cases, the adviser needs to work closely with the family and understand the business needs. The planning focus may be on family succession or maximising the value of a business on a future sale whilst reducing the likely tax liabilities on sale or death of a shareholder (where 100% relief is not available). These will remain critical issues within the UK Family Business environment going forward.

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SUCCESSION PLANNING FOR THE FAMILY BUSINESS IN THE UNITED STATES: SELECTED ISSUES

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SUCCESSION PLANNING FOR THE FAMILY BUSINESS IN THE UNITED STATES: SELECTED ISSUES

Family businesses account for over 90% of all business entities in the United States and employ 60% of the U.S. workforce. According to U.S. Census figures, over 5.5 million businesses exist in the U.S. with less than 100 employees. The Internal Revenue Service estimates that over 12 million non-home based private businesses exist. Over 50% of the workforce works for a family business. However, only an estimated 70% of all family businesses make it to the second generation, and only 10% to the third generation.

Obviously, family businesses are a huge potential market for the professional. With the high failure rate statistics, it would also appear that family businesses need a lot of help. In the U.S., family businesses have never been a focal point for large multi-national law firms. The outline below discusses some selected issues impacting family businesses.

I. <u>Owner Relations</u>. The most important and most frequently overlooked issue by the professional. If owner relations are bad, everything else follows. Owners need to understand and cherish the unique blessing of the family business. Frequently, a professional will need to act as an outside facilitator/advisor to the family. This role requires a mixture of business, financial, legal and psychological skills. Common areas of focus include:

A. Potential Conflicts in the Family Businesses.

1. Employee Family Versus Non-Employee Family. Differing rewards for efforts and equity.

2. Employee Family Versus Non-Family Employee. Inconsistent HR policies create potential problems. Equity incentives to key employee non-family members may move ownership outside the family unit.

3. Generational Issues.

4. Sibling and Cousin Rivalries.

B. The Family Business Leader. Regardless of the role of family in the actual operation of the business, families need to identify a family business leader. The family business leader will need to play a proactive role in family management and its relation with the business. If the business is still in the entrepreneurial stage, the founder is the natural choice. In later stages, identifying the family business leader is more difficult.

C. Establishing Process for Family Harmony. Processes will need to be established for dealing with family issues. Some suggested processes include:

1. Family Values Statement.

2. Code of Conduct.

3. Regular Family Meetings.

D. Different Family Financial Needs Among Owners.

1. Liquidity Needs. Family members have different lifestyles and expectations.

2. Exit Strategy. Some family members may be looking to cash out their interests.

E. Lack of Business Training. A uniform business education program may need to be developed to educate family owners on business principals.

F. Building Ownership Mentality. Owner mentality can be built by creating defined areas of responsibility for family member employees.

G. Marital Property Counseling.

1. Pre-Nuptial Agreements.

2. Divorce Issues.

II. Business Governance.

A. Board of Directors. Board of director makeup is key to the successful transition of a family business to different generations.

1. Outside Directors. Carefully chosen outsiders are usually a positive influence.

2. Non-Family Member Owner Directors. If outsiders become involved, they should generally become owners, which will mean some ownership outside the family unit.

B. Voting Trust or Shareholder Agreements. Ensure board structure and ownership group integrity. Absolutely necessary in certain instances such as S corporation status.

C. Outsiders as Key Officers. Outsider may be a positive role player as Chairman, CEO or President.

III. U.S. Tax and Legal Issues.

A. Choice of Entity. In the U.S., different entities may be appropriate for different points in the business' life cycle. Federal and state tax considerations play an important role in choice of entity decisions. The basic U.S. choices are:

1. C Corporation. Double taxation. Up to 60% to 70% effective tax rate before income reaches owners.

2. S Corporation. Single tax rate of 35% to 40%. Some double taxation in certain instances.

3. Limited Liability Company. Single tax rate of 35% to 40%. Some states tax a separate entity.

4. Partnership. Single tax rate of 35% to 40%.

B. Dynamic Entity Structure. As a business life cycle progresses, entity structure may need to change.

1. Financing Considerations. For example, venture capitalists seem to be predisposed towards C corporation structure because they are looking to the public markets as an exit strategy.

2. Business Divisions. The tax cost of dividing a C corporation or S corporation into separate businesses may be double the cost involved with an LLC or partnership, assuming no special tax-free spin-off treatment will apply.

C. Exit Strategy. All owners exit. Most owners, particularly entrepreneurs, do not give exit strategy planning sufficient attention.

1. Going Public. If successful, yields great benefits. Lockups and transaction costs reduce attractiveness as an exit strategy.

2. Strategic Sale. General rule: buyers prefer to buy assets; sellers prefer to sell stock. A disadvantageous entity structure can reduce net proceeds to seller by 20% to 30%.

3. Employee Stock Ownership Plans ("ESOP"). ESOP transactions pass equity to employees. Structure can yield substantial financial and tax benefits. Under current U.S. tax law, if the business is wholly owned by an ESOP, it can make an S election and operate tax free.

D. Estate Planning Considerations. Top U.S. tax rate can exceed 50%.

1. Stock Transfers. Reduce value of business in estate for estate tax purposes by transferring partial ownership.

2. Discount Technique Planning. Entity and ownership strategies can result in significant discounts to value in taxable estate.

3. Liquidity Issues. Large estate tax liability may put business at risk from a fire sale to pay taxes. Sinking funds and insurance, preferably held in trust outside of estate, can mitigate issues.

E. The Multinational Family Business. Increasingly, family businesses have significant revenues outside of their country of origin.

1. U.S. Family Business. Operations as a branch, a subsidiary, or a special entity. Decision depends on:

a. Applicable foreign law and treaties.

b. Potential for transfer tax minimization strategies.

c. Application of U.S. anti-deferral rules (Subpart F).

2. Non-U.S. Family Business. Operations as a branch or a subsidiary. Decision depends on:

a. Applicable foreign law and treaties.

b. Potential for transfer tax minimization strategies.

c. Type of U.S. income: active or passive.

d. Generally preferable to avoid U.S. branch profits tax regime.

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Succession issues affecting family businesses

1. Legal forms of business in Poland

1) Companies:

a) a limited liability company
b) a joint-stock company

In general, companies are not a common form for family business. In most cases, what are now family-owned companies were set up as partnerships and next converted to companies as their business grew.

2) Commercial partnerships:

a) a registered partnership
b) a professional partnership (limited liability partnership)
c) a limited partnership (limited liability of the limited partner)
d) a limited joint-stock partnership (limited liability of the limited partner)

Commercial partnerships are owners of property and they are responsible for liabilities connected with the business, while partners are responsible jointly and severally with commercial partnerships but only if the commercial partnership fails to fulfil the liability.

3) Sole tradership:

a) a sole tradership (only one person registered as owner; other people are co-workers or workers)
b) a general partnership (contract between two or more soletraders who undertake to jointly carry on business but the business is not registered)

In a sole tradership and a general partnership sole traders are direct owners of their property and are directly responsible for liabilities connected with the businesses.

2. Succession

2.1 Kinds of succession

Two kinds of succession:

a) a statutory succession

Successors in the first degree: children, spouse
Successors in the second and third degree: spouse, parents, siblings

b) a testamentary succession

A decedent can appoint one or more persons to be his/ her successors (for example, his/her business partners to the exclusion of his/her family members).

Forced heirship (*legitime*) – duty to pay off children, spouse and parents in case they are not included in the will.

2.2 Definition of inheritance (estate of the deceased)

An inheritance includes property rights and liabilities of the testator (excluding rights and liabilities closely related to the person of testator and rights which are automatically transferred to specific people, irrespective whether they are successors or not).

Inheritance:

1) Companies – shares (business property, rights and liabilities are not part of inheritance)

2) Commercial partnerships – shares in commercial partnerships and joint and several responsibility for their liabilities

3) Sole traderships – property, rights and liabilities, including those connected with the business

2.3 Responsibility for liabilities of commercial partnerships and sole traderships

General rule: responsibility for all liabilities.

How to limit heir liability:

a) acceptance of inheritance without reservations – limitation on responsibility only for those liabilities which are not subject to inheritance
b) acceptance of inheritance with the benefit of inventory
c) rejection of inheritance

2.4 Procedure

1) Statement of acquisition

Court states the acquisition of an inheritance on the motion of any person in interest. It is presumed that a person who obtained such statement of acquisition is a successor.

2) Distribution of testator's estate

- either contractual or ordered by court on the motion of one of the successors
- until distribution is completed, the successors are co-owners of the estate

3. Problems related to succession of family business

3.1. Corporate law limitations on succession

- possible only in limited liability companies and commercial partnerships
- no limitations in joint stock companies
- issues connected with trade name of the business

3.2 Contractual limitations on succession

- limitations in contracts based on the personal qualities of the donor
- polish law prohibits transactions *mortis causa*

3.3 Transfer of licence and permits

1) permit

2) license

3.4 Heirs' actions to take over the business

- registrations
- notifications of business partners, including clients and customers, creditors and debtors
- establishing proxies

4. Tax aspects of succession

- general rules on taxation of heirs
- exemption from inheritance tax