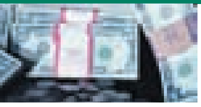

Family business, the future…

Good communication and coherent planning are the keys to the success of family businesses

By John White

It is estimated that only 33% of family businesses make it to the second generation, of which more than half are either sold or split up. A mere 15% make it to the third generation with less than 4.5% surviving beyond. What are the factors that cause two thirds of family businesses to fail in the first generation? To answer this question we must look closer at the characteristics and issues that are specific to family businesses.

What is a family business?

Family businesses are no different to any other commercial organisation when it comes to managing the challenges of the business environment. What sets family businesses apart are the distinctive issues that they must also deal with, to ensure survival of the family's legacy. Characteristic of family businesses is the instinctive loyalty of family members to the success and growth of the business coupled with their ability to make rapid decisions without being hindered by investors who are there for a shorter term gain.

It is therefore the unique mix of family and business issues that identifies a family business. Because of these unique issues it is critical to plan early for the succession of your business. This article looks at some of the principal considerations for all business owners in considering succession and emphasises the need to start planning years in advance of the event.

Conflict and the Family Council

In bringing a family relationship to a business you are operating from an emotionally based platform. With emotions come conflict and the first major stumbling block to the survival of the family business. Conflict between family members need not necessarily be in relation to real issues of strategy or management.

Research has shown that effective mechanisms for communication inside family businesses seldom exist. Conflict management is therefore critical to the success and survival of a family business. The establishment of a family council can be used to resolve such conflicts and provide a forum for family members to air their views. Such a family council would typically be separate to shareholder / director meetings and would discuss members "feelings" towards change, etc. in an open forum.

"The bone is strongest where the break heals". The same applies to relationships, and this may, in fact, give family firms a competitive edge. Unresolved conflicts are harmful and put the family and business at risk. Family businesses that have developed effective ways of managing conflict are those most likely to survive and thrive. Those who have found ways to regulate and appreciate differences of opinion, even if potentially explosive, enjoy a competitive advantage, as they are better able to work together, trust each other and react faster to the changing economic environment. It also leads to better, wiser decisions. Remember:

- Conflict is normal; differences of opinion are healthy.
- Managed conflicts are beneficial, building self confidence in emerging leaders and strengthen bonds.
- Conflict must be dealt with quickly and fairly.
- The process is as important as outcome.
- Hard bargaining is a poor second to interest based negotiations.

The Family Constitution

The development of a family constitution should also be considered, whereby the rules of participation within the family business are established. The family constitution should deal with matters such as;

- who participates in the business,
- how to select successors,
- how to cope with conflicts and personal needs,
- how to govern the business,
- how to reflect family values in the business,
- what are the rights and responsibilities of ownership of share equity,
- what income yields to expect.

Such rules bring clarity to what are normally emotive issues thus reducing the likelihood of an emotional outburst and provide a structured and transparent process for all family members to work within.

Carving out the estate

The next major stumbling block that the family business is likely to meet is that of which family member should succeed. One of the most troubling succession planning decisions is how to divide your assets when you are gone. Three factors make this division difficult for family business owners.

First, up to 80 percent of their total net worth is typically tied up in the business or business-related property. Available cash / profits are ploughed back into the business. Family business owners often awaken to the reality that they have built themselves traps by having such a large percentage of their total net worth tied up in their illiquid businesses. By planning early, certain funds can be "put aside" to facilitate the smooth transition from one generation to the next in such a way that will not cripple the reserves of the business. We'll deal with this a little later.

The second factor is determining the value of the business. While most owners have a

rough idea what their businesses are worth a valuation exercise is an important part of any succession plan. Such a valuation will also help to assess the likely exposures to Capital Taxes on transferring the business to the next generation. However SME business valuations are complex exercises.

The third factor arises when one (or more) of your children decides to work in the business and one (or more) doesn't. Should you then leave the business to your children equally? If none work in the business, the issue may be when and to whom will you sell it? The biggest hurdle family business owners must jump is the mindset of treating children equally. In dividing family business assets there is rarely fairness in the equal division of assets. Instead, owners must consider being fair and equitable. These goals can be mutually achievable. The process is to realistically determine the value of assets and arrive at a formula whereby, children who do not receive the family business, or shares in the company, will receive a percentage of that value in other assets.

Identifying a successor is not an easy task. It is important that the successor identified has the appropriate skills and experience to take on the running of the family business. A two way communication, established at an early stage, is encouraged to ensure that both of you are working towards a mutually agreed objective. The successor should bring an appropriate level of skill and experience to the business before any transfer should be effected.

Exit Strategy

However, having decided on the ultimate successor of the business is only one side of the story. Hand in glove with that plan is the exit strategy for yourself to leave the business and extract sufficient funds to provide for your retirement. Sufficient reserves should be put aside to allow you to maximise your net worth and minimise any taxes arising on the transfer. Consideration should be given to some of the following:-

1. Maximise company pension contributions. This should be done in a planned manner, particularly if you are within 10 years of retirement. Finance Act 2006 introduced a maximum capital value of a pension fund for individuals on retirement on which tax relief can be claimed at €5 million. There is also a cap of €254,000 per annum on pension contributions on which tax relief can be claimed. Review your own position and plan to maximising the benefits.

   Consideration may also be given to establishing a Small Self Administered Pension (SSAP) fund to allow you to manage the asset profile of your pension fund in the run up to your retirement.

2. Ex-gratia / redundancy payments made to directors for loss of office may be a tax efficient means of extracting funds from the company. There are a number of formulae that should be run in deciding the best option with very generous tax exemption limits available. The basic exemption allows a lump sum of €10,160 plus €765 for each year of service plus Statutory Redundancy. This basic exemption may be increased further where you opt not to take a tax free lump sum on your retirement pension. An alternative, and generally more beneficial relief for retiring business owners, is the Standard Capital Superannuation Benefit (SCSB). The SCSB formula is an amount equal to (A x B / 15) – C, (where: A = average annual remuneration for the last 3 years service; B = number of complete years service, and; C = value of any tax free lump sum received / receivable under an approved pension scheme).

3. Consider a buy-back of some of the share capital of the company. In such a reorganisation this is treated as a disposal under capital gains tax rules and liable to a tax rate of 20%. There are a number of both company law and tax issues that need to be considered carefully here so be sure and seek professional advice.

4. Plan to maximise the tax free lump sum that you can receive from your pension fund on retirement. There are a number of options available depending on your circumstances. Again, this involves at least a ten year look-back so planning early will reward you with significant savings. Finance Act 2006 capped this maximum tax free lump sum at €1.25 million.

5. Consider selling surplus / unproductive assets of the business. Retirement relief is a relief from capital gains tax where a number of conditions are met in selling the business to an unrelated third party. However these rules are complex and all the prescribed conditions must be met in order to avail of the relief.

Capital Taxes

The sale or transfer of a business attracts Capital Taxes, namely Capital Gains Tax (CGT); Capital Acquisitions Tax (CAT); Stamp Duty and VAT. The area of succession planning requires careful consideration in order to minimise the taxation pitfalls.

Tax concessions are available across most tax heads that allow you to mitigate such Capital Tax liabilities but, as with all tax concessions, there are a number of conditions that need to be met before relief is granted. Consequentially, proper taxation advice from qualified and experienced accountants or tax advisors is vital to the succession plan.

Conclusion

Good communication and structured, coherent planning are the keys to the success and survivability of family businesses. You should also appreciate that business succession is not a single event but rather a long term process of identifying talent and winning support for change. The process should involve all parties and not be developed by one individual. It should start at the earliest possible opportunity. Issues such as identifying a successor within the family and developing their skills set should be encouraged. Deciding on the time frame for succession and planning for the retirement of the present incumbent should also be taken into account, together with assessing the financial impact for the business and for the individual, that such a retirement may have.

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