by DYANNE ROSS-HANSON

AS SEEN IN Upsize Minnesota

Beware when passing firm to offspring

WHAT COULD BE EASIER than transferring a family-owned business to its natural successor, heirs apparent and offspring? For many family members, and their advisers, answers range from world peace in the Middle East to bipartisanship in Congress. Like me, they have likely experienced their share of family business transfer disasters.

Statistics, widely quoted by estate planning writers, indicate that "only" one-third of all family-owned business are passed on to the second generation, with "only" 10 percent of family-owned businesses transferred to a third generation. Experience indicates that those statistics may be optimistic and overstated.

So why such dismal results? Perhaps the next generation lacks the leadership qualities, ambition, capability, cooperation with other family members (and their spouses) and/or finances necessary to successfully lead the enterprise forward. Perhaps parents are not comfortable passing the baton as soon as the younger generation would like so growth is impeded. Perhaps a parent's own retirement income goals cannot be met without continued income from the business. The list goes on.

My pessimism notwithstanding, some family businesses are indeed successfully transferred to younger generations. For the transfer of business ownership and control from parent to child to be deemed successful there exists a myriad of issues to be considered. Below are a few nuggets to heed.

[tips]

1 | If children couldn't get along as kids playing in the sandbox, how does one expect them to get along running a multimillion-dollar enterprise?

2 | One solution might be to leave the business entirely to the business-active child and make equitable distributions of the balance of family assets to the inactive children.

3 | At the very least if more than one active child remains in the business, provide one the ability to control decision-making.

What's fair?

Fair vs. equal: Parents want to treat all of their offspring fairly. Planning an equal distribution of the family business to all children regardless of their contribution to it, is rarely fair. Perhaps one or more of the children have invested time and effort in the family business while others have chosen a different path. Should the "active" child be responsible for sustaining and growing the company for the benefit of his/her siblings? Try doing so without the ability to control decision making!

If children couldn't get along as kids playing in the sandbox, how does one expect them to get along running a multimillion-dollar enterprise? One solution might be to leave the business entirely to the business-active child and make equitable distributions of the balance of family assets to the inactive children. At the very least if more than one active child remains in the business, provide one the ability to control decision-making.

Tax minimization: A common technique parents use when they find themselves financially dependent upon stock value, but want to begin transition, is the use of cash bonuses to family members. These bonuses are awarded with the intent they be used to purchase stock. The greatest benefactor in this strategy is the IRS, taking upwards of 50 percent of the available cash flow supporting the technique.

Gifting stock can alleviate this issue but does not provide financial income to the sellers. Currently the IRS allows annual gifts of $13,000 per donee without incurring any gift tax. This technique may take some time to get a significant percentage of the business to the next generation and

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still not offer parents income if needed. Furthermore, it is not unusual for the business to represent a significant percentage of the parent's net worth.

Estate taxes, at the death of a shareholder, can require tax payment of 45 to 55 percent of its value (after exclusions) and force liquidation in order to pay the bill. While Washington continues to debate final estate tax legislation, given the current federal deficit it would appear safe to assume revenue sources aren't going away, especially when levied on the rich! Be mindful of your silent partner, the IRS. There are techniques available to mitigate their take.

Valuation: Why? Because in order to evaluate various exit strategies, you (and ultimately the IRS) need to establish a "defensible" value for the business. Company value is often dependent upon who is doing the valuation and why. Understanding the difference between enterprise value (maximum) and discounted value (minimum) is critical.

When selling to family member(s) with limited capital resources or gifting for that matter, discounted value can make the difference between success and failure. And don't forget to consider the business active child's contribution to this value. There is no need to require the active child to pay for his/her own "sweat equity" after all.

Incentives for staff

Key employee retention: This is an issue of particular importance in family businesses where successors remain highly dependent upon continued contribution and retention of key personnel. Realizing that they are unlikely to ever share in ownership, how can key employees participate in the equity they feel they are largely responsible for building? What is going to provide them the incentive to stay on through the transition to a new generation of owners? How do family businesses recruit ambitious, entrepreneurial key talent?

The answer may be in the form of "synthetic" stock. Phantom stock or stock appreciation rights can go a long way toward motivating and retaining key talent. Deferred compensation plans can be designed to give incentives for performance by meeting financial benchmarks that once achieved "self-fund" the benefits paid. Individual circumstances will help define what plan design is best suited, but do not overlook this important issue.

The back-up plan: Have one! What happens if the business active parent dies before the transfer can be completed? A buy-sell agreement or bequest at death can entitle the active child to assume control. Or what happens if the active child finds himself or herself disillusioned with the idea of assuming the lead? Perhaps he/she did not fully understand the personal and financial sacrifices necessary to continue. Or, worse yet, the parent discovers the child's lack of ability or willingness to assume risk. In these cases, a sale to key employee(s) or a third party may be the best option for everyone involved.

Yes, family business ownership transitions can and do succeed and in doing so defy the odds. The key is to begin planning well in advance of the parent's desired departure date. With professional guidance, families can design a succession strategy that includes these issues and others and yet still remains flexible for everyone concerned.

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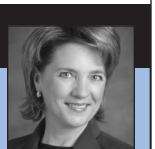

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