Transition Funding in Family Firms

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Abstract

Numerous family businesses transfer from one generation annually. An owning or inheriting generation's seeking of its share of the value of the firm can place a severe financial burden on those family members wishing to retain ownership in order to run the business. Mechanisms exist to facilitate payment of those obligations. Though many owners use external professionals for succession planning, only about half the sample in this study used insurance to guarantee that the necessary funds would be able upon death or retirement of senior family members.

Introduction

According to Ibrahim and Ellis (1994), at least 90% of our nation's over 20 million business are family owned. According to Poza (1998) a recent survey indicated at least 50% of family business owners would prefer the next generation to manage and jointly own the family business. On top of that, Upton (1998) cited a study by Avery and Randall (1993) which forecasted business bequests between 1990 and 2040 to total over $10 trillion. Owners and experts alike agree that one of entrepreneurship's most difficult dilemmas is passing the torch from one generation to the next. It is a decision laden with emotional, control, equity, and fiscal implications. However, today's entrepreneurs are going to facing this decision in record numbers in the not-so-distant future.

Literature Review

Getting family firms to the succeeding generations is not easy. Even when firms survive the high-failure early years, Ward (1988) reported that the average expectancy for a family business was 24 years, the same tenure that Beckhard and Dyer (1983) reported for the firm's founder. Ward's study also found that only 16% of 200 family firms survived into the third generation.

In a survey of 800 previously-healthy family-business failures, File and Prince (1996) found the three most common causes of failure were inadequate estate planning,

failure to properly prepare for the generation transition, and the lack of adequate funding to pay estate taxes arising from the death of the founder. According to the authors, these were healthy businesses up to that point; 91.3% had revenue growth over 5% and 92.9%% employed over 50 people. Upon failure, the average number of lost jobs per company was 128. An important point for this paper is to note that the File and Prince survey found that in 47.7% of the cases, the transition and ultimate failure was precipitated by the founder's death and that in only 16.4% did the business failure occur where there had been an orderly transition.

What distinguishes an "orderly" transition from a "disorderly" transition? According to Higgins (1998), an orderly transition minimizes taxes, keeps the business in the family, ensures good leadership, treats all children fairly, and prevents outsiders from getting in. Higgins' focus looks at both business-oriented survivors and non-business survivors. According to Poza (1998), a successful succession promotes or insures business continuity.

Founder/owner demise is not the only situation that can make a transition go bad. Succession planning can be a very complicated issue. Successors need to be identified, training needs to take place, employees need to be willing to accept the new leader, siblings (either hostile or friendly) must often be dealt with, and ownership of the firm must ultimately pass to the succeeding generation. A critical issue, however, in the passing of ownership from one generation to the next is the compensation of senior owners, and often-times non-business survivors in the inheriting generation. These latter individuals may not be involved in the firm but have a vested interest in the succession as a result of being an heir. The funding aspect of the transition may demand a level of capital and/or ready cash that exceeds the grasp of the business or its family management team.

To solve the cash dilemma, Tauer (1998) and Higgins (1998) recommend the use of life insurance with the survivors as beneficiaries and the current owners as the insured. With this type of arrangement, the business survivors receive the cash necessary to buy out the interest of the surviving family members. Thus, the family survivors are allowed access to their inheritance and the business survivors are allowed to continue to operate the business. The business, therefore, remains in the hands of those most likely to continue its successful operation. Several types of insurance exist for the purpose of funding this transaction. Black and Skipper (1994) identify buy-sell agreements for sole proprietorships, partnerships, and closely held corporations.

The prospect of large-scale turnover in family businesses during the next generation begs the question of how well prepared are these firms to meet their financial challenges without the inheriting generation losing control of the business? Given the findings of File and Prince (1996), this appears to be a serious matter. Are owners preparing for the financial obligations that accompany the transition between one generation of owners and the next? If so, how? What financial mechanism are they utilizing; with whom are they working to help plan the transition; and how satisfied are

the owners with the outcomes of their efforts? With those questions in mind, a study was conducted into the estate planning practices of family businesses in Indiana.

Method

Sample and Data Collection Procedures

The sample consisted of owners of second generation family businesses in Indiana. The goal was to gather information from individuals who had already gone through the transition process in their business. Chambers of Commerce were contacted in several metropolitan areas for assistance in developing a mailing list of such businesses within their jurisdiction. Four hundred business owners were sent a copy of the survey instrument with a cover letter that explained the purpose of the study. Follow-up phone calls to non-respondents were made where possible and brought the total sample size to 101 second generation business owners.

Instrumentation

Data were gathered by means of a 26-item questionnaire designed to determine the financial planning practices utilized by the firms. Twenty items pertained to the financial planning process and 6 items collected demographic information on the respondents. The survey instrument was pre-tested by several area second-generation business owners to determine its clarity and its ability to cover the needed dimensions of the business transition. Demographic questions included owner sex, age, and education. They also included the number of years in business, the number of business employees, and the firm's annual sales. The transition planning items related to the use of insurance, insurance policy ownership, form of business ownership, purpose policy ownership, the identification of firm members who participated in the process, and the use of external financial planning experts in the process. Most items requested that the respondent simply check the appropriate response. Some items utilized a five point Likert scale (1 = "not at all" to 5 = extensively) to determine the extent that a concern was important or an activity was participated in.

Data were analyzed to determine a business and respondent profile. Descriptive statistics were also used to determine the methods of transition planning, the use of insurance, the involvement of various people in the planning process and other items of interest.

Results

Sample Demographics

The demographic profile of the sample is presented in Table 1. Eighty-three of the owners were male, five were female, and the remaining firms were mixed-sex partnerships or corporations. Over 60% of the firms had been in business more than 25 years. Sixty-one firms reported annual sales of greater than $1,000,000 and fifty-two respondents had at least a college degree. Fifty-six business owners reported having a business succession plan and sixty-nine indicated that they intended to have a family member take over the business should they have to leave for reason of death or disability.

Table 1
Sample Demographics

Gender:	Male	82.2%
	Female	5.0
	Combination	12.9
Age:	35 or under	3.6%
	36-45	18.1
	46-55	39.8
	56+	38.6
Years in business	0-10	6.4%
	11-25	30.8
	26-50	45.8
	51+	17.0
Number of employees	1-10	26.3%
	11-25	30.5
	26-50	19.0
	51-100	12.6
	101+	11.6
Education level	High school	20.5%
	Some college	20.5
	College graduate	37.5
	Some grad school	1.1
	Graduate degree	20.5

Annual sales	$200,000 or less	7.5%
	200,001 to 500,000	7.6
	500,001 to 1,000,000	19.4
	1,000,001 to 2M	21.5
	2,000,001+	44.1

Do you have a succession plan?

Yes	55.4%
No	45.5

To whom do you intend to leave the business in the event of death or disability? (n reported due to some duplication in responses)

Family member	69
Loyal employee	22
Friendly competitor	1
Other	17

Use of Business Life Insurance

Seventy owners indicated they used business life insurance, some for multiple purposes. Of those, 27 used it for business continuation purposes and 29 to provide liquidity to pay estate taxes, thus 56 actually used the insurance in the continuation planning process. In 52 cases the business was the actual owner of the policy and 40 of those firms were also the beneficiary. Other owners and beneficiaries included partners, spouses, and other family members. See Table 2 for data on the use of insurance for continuation purposes.

Table 2
Use of Business Life Insurance

Business life insurance exist?	Yes	70
	No	31
Is life insurance used for business continuation	Yes	56
	No	45
Who owns policy	Business	52
	Spouse	12
	Other family member	10
	Partner	7
	Sole proprietor	5

Beneficiary	Business	40
	Spouse	24
	Other family member	16
	Partner	10
	Sole proprietor	1

Individuals in the Process

In the continuation planning process, two issues that must be confronted. One choice concerns the type of professional advisor will be utilized to actually work on the transition planning from a logistics perspective and the other concerns what type of professional will assist in the implementation of the plan. The opportunity for duplication across these choices exists. The primary options in the planning portion of the process include individuals who would be knowledgeable of the financial and tax implications of various types of decisions, such as attorneys, accountants, certified financial planners, stockbrokers, and insurance providers. Certified financial planners, stockbrokers, and insurance agents (all within some limitations) can assist in the implementation of the plan. The implementation process involves the acquisition of the appropriate financial instruments to assist with the financial ramifications of business transition. To plan for business continuation, the most common choices were accountants (n = 88) and attorneys (n = 79), obviously indicating the use of multiple perspectives. Thirty-three owners indicated using insurance agents and eleven said they used certified financial planners. From the business perspective, the 101 owners indicated a total of 116 people (with some people apparently carrying dual titles) were responsible for dealing with advisors. The CEO (n = 37) and the president (n = 74) were the overwhelming responses. Few owners left it to others such as accountants (n = 7) or comptrollers (n = 10) or others (n = 18). Again, the majority of people left it to the CEO and/or president was/were the overwhelming choice with 35 and 74 selections respectively.

Table 3
Individuals Involved in Transition Planning Process
(percentages will exceed 100% due to multiple involvement)

External	Accountant	87.1%
	Attorney	78.2
	Insurance agent	32.7
	Certified Financial Planner	10.9
	Professional Consultant	5.0

Internal	President	73.3%
	CEO	36.6
	Comptroller	9.9
	Accountant	6.9

Ability to Avoid Tax Liability

One of the primary reasons to engage in this type of planning is to legally minimize the tax liability which falls on the owners, heirs, and/or the firm upon transition from one set of owners to another. The owners were asked to indicate the extent to which tax planning was implemented so as to limit the inheritance tax burden. On a scale of 1 to 5 ("not at all" to "extensively"), the average response was 2.77. This would fall only slightly to the left of the mid-point, indicating that tax planning had not been extensively used by this group to avoid inheritance taxes. Seventy-five subjects responded to a question concerning the extent to which they were able to avoid inheritance taxes as a function of tax planning. Twenty-seven (36%) indicated they were able to avoid them completely, 24 (32%) responded they were able to avoid the majority, and 11 (14.7%) responded they avoided a fair amount. Thus it appears that for this group, tax planning had been fairly effective.

Table 4
Ability to Avoid Inheritance Tax Liability

Avoided completely	36.0%
Avoided majority	32.0
Avoided a fair amount	14.7
Avoided very little	12.0
Avoided none	5.3

Satisfaction with Outcomes of Planning

Three items dealt with issues related to the outcomes of the transition planning process. These were measured via a 1 to 5 Likert scale ("not at all" to "very"). Overall, the owners responded that they were fairly satisfied with the status of their transition planning (mean = 3.347). Similarly, when asked how confident they were that their transition planning will be effective the mean response was 3.608. Finally, when asked how confident they were that their transition plan will facilitate the continued growth of their firm the mean response was 3.484.

Table 5
Satisfaction with Transition Planning Outcomes

Satisfied with status of transition planning	
5 = Very	23.2%
4	27.4
3	25.3
2	9.5
1 = Not at all	14.7
Confident in effectiveness of planning	
5 = Very	25.8%
5	38.1
4	17.5
3	8.2
1 = Not at all	10.3
Confident that planning will facilitate future growth of firm	
5 = Very	23.7%
6	35.1
5	21.6
4	5.2
1 = Not at all	14.4

Discussion and Conclusions

There is much to be drawn from the results of the present study. Additionally, many questions emerge that warrant further investigation. While this group, or its preceding generation, appears to have been fairly active in transition planning, there also seems to be some dissatisfaction with the planning's outcomes and some room for improvement.

For example, only a little more than half used insurance to provide the liquidity necessary for transition. What do the rest do? While it is reasonable to expect that most, if not all, of the owners in the sample have insurance of some type and insurance agents, why have these agents not been more active in developing the market for transition planning advising. Attorneys and accountants seem to have a relatively tight grip on the transition planning market even they are not totally equipped to facilitate the entirety of the process.

Why is there such limited use of tax planning when it appears to be fairly successful? An explanation may lie in the possibility that many first-generation owners

failed to use tax planning. It is now left for succeeding generations of owners to be more prudent when planning for the next transition. This group may be more involved because they are at least second-generation owners. Succeeding generations may benefit from this lack of concern for tax implications of transition; the present generation may not have gotten as much money as they could have but they may be more determined to avoid this mistake in the future.

On the whole this group could be very satisfied with its planning because they see it as fairly effective. Thus it appears that for this group, tax planning had been fairly effective. The satisfaction/confidence measures reflect moderate satisfaction but room for substantial improvement. To some extent one might expect slightly higher responses based on the percentage of owners who indicated they had been able to avoid large portions of their inheritance taxes. This difference might be explained by the fact that one quarter had not responded to the inheritance avoidance item.

One could say that that there is room for improvement in the planning but one item that could shed light on that subject is whether there is a difference between second-generation owners and subsequent-generation owners. Did second-generation owners lose more than they expected (or hoped) to lose because of inexperience and hoped to avoid that problem in the future? Do they see their inexperience in transition planning and believe they are the wiser and more prepared for it because of that error?

The success of transition planning will vary with the quality of the assistance provider but it does seem that they can make a difference. The stakes to the individuals involved can be high in terms of tax and other liabilities all the way to the subsequent loss of the business. The upcoming decade or more may see substantial numbers of businesses facing transition and its ramifications. Hopefully, family business owners will be prepared for the challenges that lie ahead.

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