Transitioning family businesses a complex matter

Timing, taxes, estates issues among major considerations for parents

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'Frequently, parents pour all their money into the business and then won't let go of it because they expect their retirement funding to come from that source,' says Mary Wahbi.

Most parents put their kids first unless the issue is transitioning a family business.

It's not that the kids and their future aren't on parents' minds. It's just that most of them don't realize just how complex the transition process is.

"You can't just do it by deciding that you're going to do it there and then," says Mary Wahbi of Toronto's Basman Smith LLP. "You need to think about it ahead of time."

Indeed, the process tends to be full of surprises.

"For every transition issue that can be identified, there are three or four waiting in the weeds," says Scot Patriquin of Toronto's Brauti Thorning Zibarras LLP.

A good time to start the planning is when the parents are in their late 40s or early 50s.

"They need to come at the plan with a vision for their children, their own life plan, and where they want the business to go," says Wahbi.

"The succession should also tie in with the estate plan, especially if only one or some of the children will be involved in the business."

To start with, deciding on a transition plan that passes a family business to the next generation is rarely a no-brainer. There are other choices that should be considered, such as selling to internal management or a third party.

If there are no children who are old enough and who have the necessary skills, family succession obviously isn't going to be in the cards. If there are, a good start is a family meeting to ascertain who's interested and whether running the family business fits in with their aspirations.

Even if there are enthusiastic successors at hand, it's important to train the next generation to understand the business and how it works.

"Training from the bottom up is what really works because they can't become leaders before they become competent," says Wahbi.

"It would be like giving your child a car before they got their driver's licence."

Indeed, Wahbi suggests parents have their children get involved in third-party businesses or pursue careers elsewhere even before they start on their in-house experience.

"Let them be employees before they become bosses," she says. "It's a good, humbling learning experience that has no safety net and sends them off to the family business with the self-esteem that comes from knowing they can work elsewhere."

Wahbi also recommends having an independent member on the company's board.

"The idea is to bring in a neutral experienced person who doesn't come with the issues and emotions that pervade the family package," she says. "That person will have nothing at stake but the viability and success of the business."

Bryan Haynes of Bennett Jones LLP's Calgary office goes further, suggesting that outside management can be a good idea.

"Whatever skills the children have, they may not be the right people for a COO or CFO position," he says. "Don't assume family members need to be on top of the hierarchy."

Parents should also consider how they'll manage conflicts, both between generations and among the children themselves.

"I had one client who ran a successful business with a partner for 45 years and they never even had a shareholders' agreement," says Wahbi.

"But that didn't work for the next generation because they didn't have the experience of building or facing adversity together."

An agreement with mediation and arbitration clauses and buyout provisions is a necessity.

"The only resort otherwise may be nightmare litigation in the form of a winding-up application in the courts," says Wahbi.

"And litigation in a family setting is disastrous because relationships never recover from it."

Another essential is to get a proper valuation of the business. "Generally, owners have no idea what their business is worth," says Wahbi.

"They usually think it's worth way more or much less than it really is."

A basic mechanism in many succession plans is an estate freeze.

"The idea is to establish value at some point in time and then carry out a transaction that will freeze that value which will be embedded into preferred shares that the parents will own and at some point turn into cash by redeeming them," says Patriquin.

"The successors get newly issued common shares, which allows them to participate in the company's growth. In some cases, the parents get some of the common shares, but the point is that either way everyone has a fresh start."

The shareholders' agreement should also deal with voting control.

"The essential questions here are how decisions will be made in the short term, how voting control will change during the transition period, and how will it look after the parents are out of the picture," says Patriquin.

Wahbi also suggests parents initiate charitable undertakings at the family or corporate level.

"Charity requires siblings to work together as a group making altruistic decisions that benefit others and discourage overindulgence, which can be a real issue when a new business is handed over to the next generation," she says.

"Thinking of others helps in the maturing process and is also a good marketing tool."

Finally, parents should be careful to separate their retirement funding from the business.

"Frequently, parents pour all their money into the business and then won't let go of it because they expect their retirement funding to come from that source," says Wahbi. "What can happen is that the parents will want to take money out, which may conflict with the successors' ideas and goals."

Tax considerations, of course, have an important place in all of this. "The overarching consideration is to transfer wealth in a tax-efficient manner," says Patriquin.

Family law considerations also come into play.

"Whether a child is married or not is a very important consideration in terms of what the child receives from his or her parents," says Andrew Feldstein of Toronto's Feldstein Family Law Group Professional Corp.

"A gift before marriage becomes an asset on the date of marriage that retains its value on that date in terms of the net family property deduction on the date of separation. The value of a gift or inheritance received during the course of the marriage traces to the date of separation."

But that's not the most daunting feature of family law considerations.

"A separated spouse may be able to obtain all sorts of confidential information from the in-laws if the child has shares in the business," says Feldstein.

Despite the weight of the issues, there have been many successful family transitions and high-profile ones at that.

"Think of Bombardier, Peladeau, and Desmarais just to start," says Haynes. "But I've also seen a lot of unfortunate situations where one generation left behind a structure that was completely inefficient and resulted in the demise of the enterprise."

By way of example, it's important not to saddle successors with an inefficient board or ownership structure, especially where multiple siblings are involved.

"Notions of fairness and equity can only go so far," says Haynes.

"Find out who is most interested and most capable and make it clear that that individual will be the leader." LT