Families in Business

MAKING FAMILY BUSINESS MATTER

Passing the Baton

Succession planning among ultra-high-net-worth family businesses

A special whitepaper report by:

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Passing the Baton: succession planning ...

INTRODUCTION

While there has been a great deal of attention paid to succession issues among family businesses, until now no one has examined the matter with respect to the exceedingly wealthy. This special whitepaper report is the first look at 242 ultra-high-net-worth (UHNW) businesses. Herein we will review key research findings, and we will provide a case study on transferring a business between the generations where the tax burden is mitigated.

In the third quarter of 2007 we surveyed 242 owners of significant family businesses. To participate, each owner had to be a senior officer of the company with a seat on the firm's board of directors. They also had to have a personal equity share of the company of 10% or greater.

We refer to these businesses as UHNW family businesses because they meet two criteria:

- A single family owns 60% or more of the business.
- The value of the business exceeds US$200 million.

With respect to the second criteria, the family businesses comprising our sample had a mean value approaching three-quarters of a billion US dollars. The median value was US$572.5 million (Exhibit 1).

Exhibit 1. Value of the business

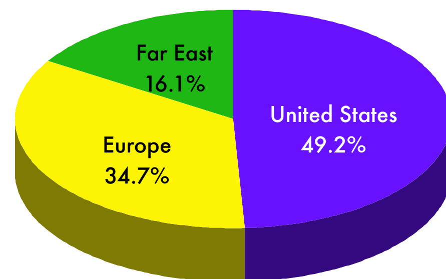
Mean	US$731.3
Median	US$572.5

n=242 UHNW family businesses

Our sample of UHNW family businesses came from three broadly defined geographic locations: the United States, Europe and the Far East (Exhibit 2). While we tie these family businesses to these locations, it's important to recognize that most of them have subsidiaries and business connections that extend into other geographic areas.

What proves to be most significant is that we segmented the UHNW family businesses based on psychographics. Using the statistical procedures of factor analysis and cluster analysis, we were able to identify two behavioral segments (Exhibit 3). The decision-making surrounding the Business-focused segment is all about the business. The needs and wants of the family inside and outside the business is not a meaningful consideration when it comes to decisions affecting the business. The Business-focused family business is a business first and a family operation second – if at all.

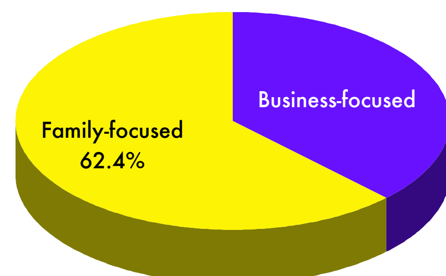
Exhibit 2. Geographic locations



n=242 UHNW family businesses

In contrast, the Family-focused segment is all about the family. Here, the business is the mechanism to enable the family to achieve and address family concerns and issues. The Family-focused family business is about the family first and foremost. The business is the source of wealth and is in service to the family – and decisions concerning the business are made accordingly.

Exhibit 3. Psychographic segments



n=242 UHNW family businesses

What we found informative was that the Business-focused family businesses were, on average, worth more than the Family-focused family businesses (Exhibit 4). While we cannot determine the direction of causality, or even if there's a

Exhibit 4. Business valuation by psychographic segment

BUSINESS-FOCUSED	
Mean	US$814.3
Median	US$694.2
FAMILY-FOCUSED	
Mean	US$681.2
Median	US$499.1

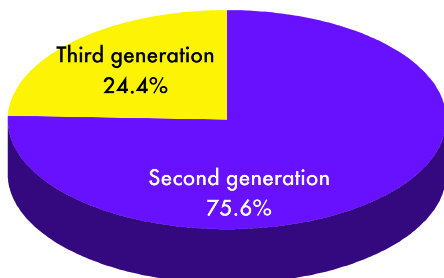
n=242 UHNW family businesses

direct causal relationship, what's telling is that, going forward, greater financial resources are being controlled in situations where business decisions supersede family decisions.

SUCCESSION IN THE UHNW FAMILY BUSINESS

All these family business have successfully moved beyond their founders. Three-quarters are in the second generation, and the remaining quarter are in the third generation or later (Exhibit 5). Therefore, as a family business they clearly have

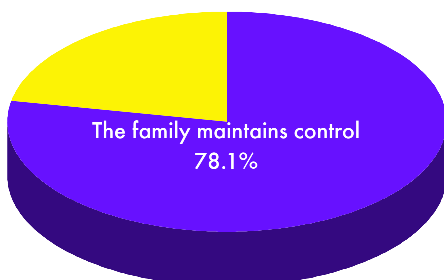
Exhibit 5. Current controlling generation



n=242 UHNW family businesses

experience with succession planning and implementation. However, as we'll see, many of these family businesses are not currently adequately addressing the succession issue.

Exhibit 6. Keeping family control



n=242 UHNW family businesses

Nearly four out of five of the UHNW family businesses are expecting, desiring, to keep control of the business within the family as they move into the next generation (Exhibit 6). Not surprisingly, this is more the case among the Family-focused family businesses than among the Business-focused family businesses (Exhibit 7).

The motivations vary for deciding to relinquish family control (Exhibit 8). However, the appeal of "cashing out" dominates. At the same time, nearly 60% find they do not have suitable family members to take over the business. Fewer

Exhibit 7. Keeping family control by psychographic segment

Business-focused	62.6%
Family-focused	87.4%

n=242 UHNW family businesses

see relinquishing control tied to new business opportunities, while only 11.3% see it as a way to downplay the role of family involvement.

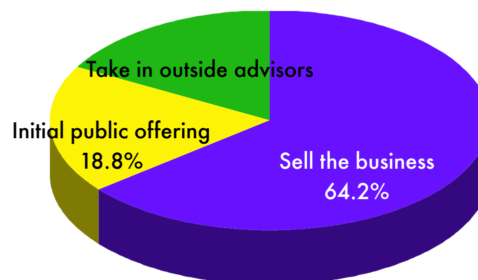
The most likely way for the family to exit the business is by selling it to another company (Exhibit 9). Less than one in five see an initial public offering as a possibility. A similar percentage are looking to stay involved while diluting their position by taking in outside investors.

Exhibit 8. Motivations to relinquish family control

Cash out	81.1%
No viable members as successors	58.5%
Expand business opportunities	35.8%
Mitigate the influence of the family	11.3%

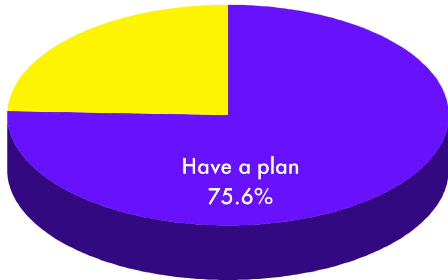
n=53 UHNW family businesses

Exhibit 9. Exit strategies



n=53 UHNW family businesses

Exhibit 10. Have a succession plan



n=242 UHNW family businesses

THE SUCCESSION PLAN

Whether it's a matter of cashing out or passing the business down a generation, about three-quarters of the UHNW family businesses have a plan (Exhibit 10). A succession plan is much more prevalent among the Business-focused compared with the Family-focused family businesses (Exhibit 11).

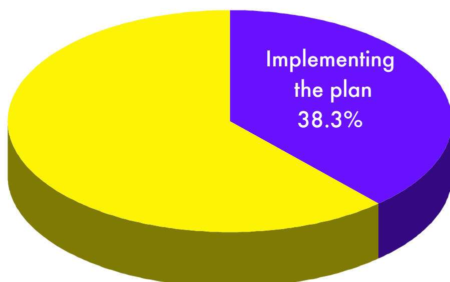
While succession plans are far from uncommon, we found that relatively few of the UHNW family businesses are actually implementing them (Exhibit 12). Whether the plans are good or bad is not in question. What is evidenced is that having a plan is not sufficient if it sits on the shelf collecting dust – as is the norm. The Business-focused family businesses were much more likely to be taking action than the Family-focused family businesses – basically twice as likely (Exhibit 13).

Exhibit 11. Have a succession plan by psychographic segment

Business-focused	90.1%
Family-focused	66.9%

n=242 UHNW family businesses

Exhibit 12. Implementing the succession plan



n=183 UHNW family businesses

Exhibit 13. Implementing the succession plan by psychographic segment

Business-focused	53,7%
Family-focused	25.6%

n=183 UHNW family businesses

THE NATURE OF THE SUCCESSION PLAN

Most UHNW family businesses have succession plans that are sitting on shelves somewhere – out of sight, out of mind. For those with succession plans, we were interested in their orientation. That is, the question as to how how important it is to the family to address:

- Strategic business issues.
- Family issues.
- Tax mitigation issues.

For about three-quarters of the UHNW family businesses, the strategic issues dominated (Exhibit 14). For half of them the family issues were extremely important. Only a quarter of them cited tax mitigation as being extremely important.

When we examine the importance of these issues through the lens of psychographics, differences are made clear (Exhibit 15). While strategic issues dominate for both, half the Family-focused family businesses have made the family issues a critical component of their succession plans, while only 14.6% of the Business-focused family businesses have done so. Meanwhile, about half the Business-focused family businesses and only a quarter of the Family-focused family businesses

Exhibit 14. Extremely important in the succession plan

Strategic business issues	72.7%
Family issues	55.2%
Tax mitigation issues	26.8%

n=183 UHNW family businesses

Exhibit 15. Extremely important in the succession plan by psychographic segment

ISSUES	BUSINESS-FOCUSED	FAMILY-FOCUSED
Strategic business issues	81.7%	72.7%
Family issues	14.6%	55.2%
Tax mitigation issues	46.3%	26.8%

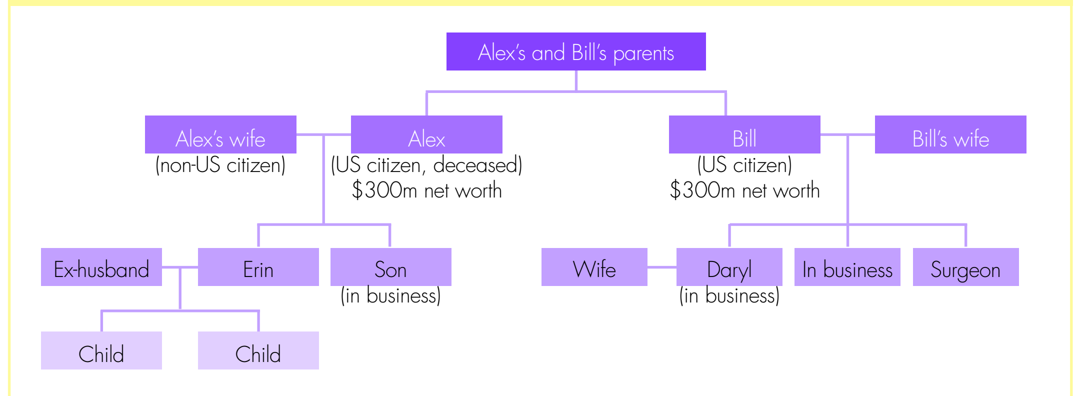
n=183 UHNW family businesses

are actively addressing mitigating taxes as part of their succession plans.

Although "mitigating taxes" is at the bottom of the list for these family businesses, 93.4% of them report wanting to lower the tax bill associated with transferring their family business to whomever. We repeatedly find that the tax issues are repeatedly attended to after these other matters have been dealt with. All too often, doing so limits what can be done to lower the various taxes that have to be paid.

Let's now take a look at the monies that can be saved by being proactive regarding tax mitigation.

Box 1. Case study: "family snapshot"



CASE STUDY: "ALEX AND BILL"

Alex and Bill were brothers who immigrated to the United States over 40 years ago and became US citizens. Alex had two children and Bill three (Box 1). When Alex died suddenly he left essentially all of his property to a qualified domestic trust (a "QDOT"), for the benefit of his wife. The QDOT was required to obtain an estate tax marital deduction since Alex's wife never became a US citizen.

Alex's daughter, Erin, works in publishing and has two children of her own. Her ex-husband ran one of the family businesses. After 12 years of marriage, the divorce and her ex-husband's subsequent departure adversely impacted that particular enterprise for a number of years, and the family is now reluctant to allow in-laws to hold any positions of responsibility. The divorce settlement also cost Erin $20 million.

Alex's son and two of Bill's children work in various family enterprises. Daryl, Bill's oldest son, runs the family's real estate investments and is married. Of course, that didn't stop him from recently having an affair with a company employee. She left the company with a generous severance package, and Bill believes Daryl's wife does not know anything happened, but he cannot be sure. Bill's third child is a surgeon in Atlanta.

Alex and Bill were serial entrepreneurs. They loved to take an idea, develop it into a business and watch it grow. The more mundane tasks of operating a business, however, were just not as exciting. Over the last 40 years they developed and sold a number of very successful businesses. Sometimes they kept one, particularly where a child had an interest in running it. When Alex died they were in the middle of what they hoped would be their most successful venture to date. It was a 50/50 partnership as always (Box 2), and at Alex's death its value was appraised at around $200 million. Unlike earlier businesses, this one could be efficiently franchised, so the plan was to grow it for the next 10 years and then go public.

Bill and the QDOT also own substantial commercial real estate holdings, everything from strip malls to suburban office buildings to a 30-story office building in a major US city. They have a real estate management company that Daryl runs. Net equity in the properties is around $150 million, although there is substantial debt associated with the real estate. Their other businesses are worth $85 million and have fairly predictable cash flows with modest growth rates. Bill and the QDOT each have a traditional equities portfolio of $75 million. In the alternative investment space, Bill and Alex tended to avoid hedge funds, but private equity always appealed to their entrepreneurial spirit, and they each committed $30 million to private equity deals. Including their personal residences and vacation homes, the brothers were each worth over $300 million.

THE "UNCLE TRUST"

Ten years ago, Alex and Bill's uncle, Charlie, who lived in London, died and left a Jersey trust worth $1 million for the benefit of them and their descendants (the "Uncle Trust"). That was when we first met Alex and Bill. They wanted to know if it made sense to keep this foreign trust, or if they should just dissolve it.

Trusts like the Uncle Trust are interesting. Because they are created by nonresident aliens, they are exempt from the generation-skipping transfer tax ("GST"). Stated simply, the GST is imposed on gifts or bequests to beneficiaries who are your grandchildren or more remote descendants. It is also imposed on distributions from trusts to the grandchildren or more remote descendants of the person who funded the trust. The rate is the same as the estate tax, 45%. Because the Uncle Trust was exempt from the GST, it could make distributions to Alex's and Bill's children or grandchildren without any additional tax being due. Because the Uncle Trust was created in Jersey, it was not subject to the rule against perpetuities. This means the Uncle Trust can continue indefinitely, whereas most trusts in the US are required to terminate after 100 years or so. Because of these two features, if Alex and Bill let the $1 million Uncle Trust grow, it could make distributions to their children, grandchildren or even great-grandchildren in a very tax-efficient way. We therefore recommended they retain the Uncle Trust.

A foreign trust that is exclusively for the benefit of US

Box 2. Assets

BUSINESS: SPLIT 50/50 – ALEX'S ARE IN QDOT

Real estate	$150m net equity and debt
Franchise	$200m
Other	$85m

NONBUSINESS INVESTMENTS

Traditional equity	$75m each
Private equity	$30m each

OTHER

"Uncle Trust"	$1m per annum

persons, however, does create certain complications. There is additional reporting when such a trust makes investments in the US or when it makes a distribution to a US person. Since a foreign trust that invests in foreign assets normally would not pay any US tax, there is also an antideferral regime to contend with whenever a distribution is made to a US person. That regime can be punitive, and even confiscatory. As a result, we recommended they domesticate the Uncle Trust and make it a US trust, which they did.

INSURANCE NEEDS

As we learned more about Alex and Bill, we realized they were buying a lot of different kinds of insurance policies for their businesses, including various property and casualty policies, business interruption insurance, sexual harassment coverage, etc (Box 3). There were also certain policies that they wanted to buy but did not because of the cost, such as directors and officers (D&O) insurance and terrorism insurance for their real estate holdings. These insurance policies were very expensive, but it was rare for a claim to be made. We discussed the idea of using a captive insurance company to help obtain the insurance they needed in a more cost-effective manner.

A captive insurance company can be established in the US or in various offshore jurisdictions that have adopted legislation permitting captive insurance companies. The licensing and government reporting obligations of a captive insurance company are substantially lower than those for insurance companies in general. In addition, the annual licensing fees are modest. The tax rules governing captive insurance companies are quite favorable as well. The business that is paying the insurance premium gets an income tax deduction, yet the insurance company does not recognize the premium as taxable income when it is received. A situation where one taxpayer gets a business deduction but no other taxpayer recognizes income is rare, but it works when you use a captive insurance company. Income the captive earns on its insurance reserves may or may not be taxable depending on how much premium is received by it each year. To the extent claims on the insurance policies issued by the captive are less than the premiums received and the earnings on those premiums, there is a net saving for the family. What's more, if an insurance claim is paid out, that insurance payment is not taxable income to the insured. After a great deal of discussion, it was agreed that an offshore captive insurance company made sense. It was a perfect investment for the Uncle Trust. With almost $1 million in premiums being generated each year and very few claims being made, the captive insurance company, which is wholly owned by the Uncle Trust, has rapidly grown to almost $15 million.

PASSING ON THE BUSINESS

After Alex's death, Bill and Alex's widow began focusing on passing the business to the next generation. They wanted to be sure that the transition of daily operations was smooth, they wanted to keep the business in the family, and they wanted to pay as little tax as possible. Of course, Bill was not quite ready to give up control either.

The family was very close, so even though two of the children were not involved in any of the family businesses, Bill and Alex's widow were not worried about the "free rider" problem faced by many families. Even if some of the children were not involved in any aspect of the family business holdings, it was too early to know which grandchildren eventually would be interested in those businesses, let alone which would have the financial acumen to take on leadership positions. More fundamentally, this was an enterprise Alex and Bill had built together, and they always intended to benefit the whole family. That intention did not change with Alex's death.

We discussed traditional estate-planning options, such as GRATs, selling assets to a grantor trust, partnership freezes, and charitable lead annuity trusts (since the family was quite charitably inclined). They agreed to implement a number of those options using some of the other family businesses, as well as their investment portfolio and income-producing real estate. Such techniques, however, simply did not work for the franchise business because it was reinvesting all the cash it generated to fuel its expansion. To establish its position in the market, the franchise business needed to open as many new locations each year as possible, and it often provided financing for franchisees. Even a minimal drain on cash flow was unacceptable, and we simply could not make the numbers work using conventional techniques.

TRANSFERRING THE FRANCHISE BUSINESS

In this case, the Uncle Trust created an interesting opportunity. The Uncle Trust was already worth around $15 million and benefited all of Alex's and Bill's descendants. It was not

Box 3. Insurance

INSURANCE ON BUSINESS INTERESTS

- Property/casualty
- Business interruption
- Sexual harassment

UNAFFORDABLE INSURANCE

- Directors and officers
- Terrorism (real estate)

subject to the rule against perpetuities, and it was exempt from the generation-skipping transfer tax. With those attributes, the Uncle Trust was an excellent place to transfer the business. The issue remained how to do it.

After a great deal of discussion and modeling various scenarios, the family agreed that a series of equity options was the best way to proceed. Essentially, the Uncle Trust entered into a collar with Bill and the QDOT. The Uncle Trust bought a call from Bill and the QDOT with a strike price of 120% of the current appraised value of the company. Under the terms of the call, the Uncle Trust has the right to buy the company in a certain number of years for the strike price. Simultaneously, the Uncle Trust sold a put to Bill and the QDOT with a strike price equal to 95% of the current appraised value of the company. As a result, when the options mature, if the price of the company has dropped by 5% or more, Bill and the QDOT could force the Uncle Trust to buy the company. If the company appreciates by 20% or more, the Uncle Trust will exercise its call right to buy the company. Given the rapid growth of the business, the second scenario is far more likely.

A critical element of this planning was pricing the put and the call. Appraisals were obtained for the business itself, as well as the two options. There was a full negotiation between the corporate trustee of the QDOT, Bill, and the trustees of the Uncle Trust in order to fix the terms of the options, and Black–Schoales modeling formed the basis for the negotiation. This is not the place for playing games or cutting costs. A quality appraisal and an appraiser who is willing and able to defend his work are critical elements of a plan like this.

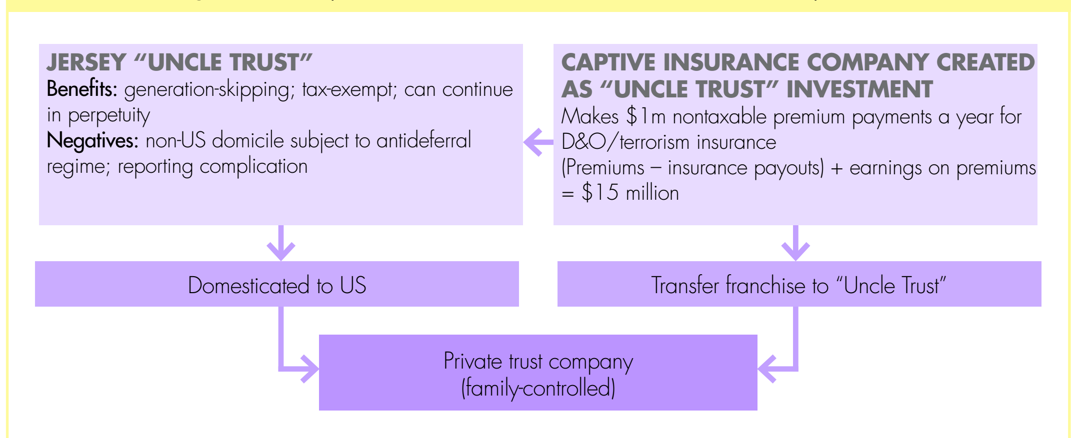
Because the Uncle Trust would eventually control the company, the family decided to change the governing law and situs of the Uncle Trust to a state that allows for a private trust company. Making these changes is not always easy. Depending on the terms of the governing instrument and state law, it may not be possible at all. When we advised on domesticating the Uncle Trust from Jersey we prepared the new US trust, so in this case it was a fairly straightforward process.

Certain US and offshore jurisdictions permit the creation and operation of private trust companies without the substantial reporting and capitalization required of commercial trust companies. A private trust company, however, can usually serve only one family. There is no tax advantage to a private trust company, but in this case it helped resolve Bill's concern about ongoing control of the company. Until the option is exercised, he and the QDOT continue to control the company. At the end of the option period, the private trust company would be the trustee of the Uncle Trust, and control would, therefore, remain with the family.

If we flash forward to when the options mature, the Uncle Trust will pay $240 million for the company, leaving Bill and the QDOT with cash. This is only 20% above the current value of the company. Based on the growth projections of the family, there will be several hundred million dollars of additional equity captured tax-free by the Uncle Trust. The exercise of the option would trigger a capital gains tax. For the QDOT there would be less gain, because when Alex died his family received a basis in the business equal to its value at his death. For Bill's family it would be more, but the capital gain tax is only 15%, instead of the estate tax rate of 45%. What's more, since the gain is triggered by a sale and not by a person's death, there would be cash available to make the tax payment. To the extent Bill or the QDOT have unused capital losses, they could also be used to offset this gain.

Perhaps most importantly, the company would be owned by a GST-exempt perpetual trust that not only keeps the business in the family forever free of any further transfer taxes, but also provides tremendous creditor protection for the family, including protection in case any more of the children or grandchildren get divorced. The private trust company also provides a method for Bill to maintain control over the business even after it is sold to the Uncle Trust.

Box 4 conveniently summarises the implementation of the succession plan as discussed in the above. ●



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