Business Succession Plan — How The Advantage May Be Given To The Child Keeping The Business

By Andrea Pontoni

I'm writing this article as, over my career as a Business Valuator and Professional Accountant, I have seen business succession plans where the intent of the plan was to be fair to all family members, however, the plan fell short of this objective.

A bit of background information on how a parent may transfer the business over to a child in a succession plan while trying to minimize the financial burden to that child.

The parent decides that at a point in time he or she would like to transfer control and growth of their business to their children. One of the critical pieces of information required to do this is a proper independent business valuation.

A typical strategy, in a business succession plan, is that the parent exchanges his/her voting shares in the business for non-voting, fixed value, special shares. The parent essentially takes back, through a different class of non-voting shares, the value of the business at the point in time he or she wishes to transfer the business over to the children. The value taken back by the parent is paid to the parent by the business out of future business profits and forms part of the parent's estate and typically assists in funding the parent's retirement. The child taking over the business would then subscribe for voting/controlling shares of the business at a nominal amount, say $1, therefore not financially burdensome to the child.

The succession plan strategy is only fair to all family members, including children who do not participate in the business, if, and only if, a proper business valuation is completed. The reason being is that only a fair value taken back by the parent will make their estate whole.

Let us break down the strategy — say you have a family business, child 1 participates in the business and wants to take over the business when the parents are ready to retire. Child 2 has no interest in the business as she/he has his/her own career.

A typical initial step for the family, when contemplating a succession plan, would be to contact their Accountant.

The Accountant may recommend a strategy similar to the one discussed above where the parent takes back fixed value non-voting special shares equating to the value of the parent's business at the point of transfer to child 1.

The question is who prepares the business valuation for the business transfer? This is a very important question because if the business is valued too low, then the value taken back by the parent is below fair market value.

What are the implications? Well the first is that **Canada Revenue Agency** may impose significant tax penalties on the transactions. The second, which is most often overlooked, is that the parent's estate is not made whole.

You might be saying, "Who cares" the benefit of the lower value for the business was given to child 1. What about child 2? Remember the parent's objective was to be fair to all family members. Child 2 participates equally in the estate of the parents through their Will.

I have often seen that the Accountant recommends that his or her firm prepare the business valuation internally.

Let us look closer at this recommendation.

The parents have typically paid significant annual and recurring accounting, tax and consulting fees to the Accountant to take care of the business' reporting requirements. When child 1 takes over the business, they have the option of keeping the parents' Accountant as their advisor or transiting to a new advisor. The Accountant and the accounting firm certainly want to keep the business as it may form a significant component of the firm's annual revenue. Child 1 would certainly benefit from a lower business valuation at the point of transfer from the parent. There would be less money having to be paid out of future profits by the business to the parent's estate after child 1 takes over. The difference retained by child 1.

So I ask you — is the Accountant or the accounting firm the best advisor to provide a value of the business at the point of transfer from the parent to child 1? Is the Accountant or accounting firm independent enough, both in fact and appearance? I would argue not, if you truly want to be fair to all family members.

The problem that I have seen is that the Accountant recommends that their firm can prepare the business valuation internally; even though the accounting firm may not be independent in fact and appearance. The accounting firm is motivated to keep the annual and recurring accounting, tax and consulting revenue after child 1 takes over the business.

Further, the Accountant may not even possess the required credentials and experience to prepare the business valuation, such as a Chartered Business Valuator ("CBV") designation through the Canadian Institute of Chartered Business Valuators or the ASA designation through the American Society of Appraisers.

There are sufficient independent and qualified Business Valuators in the Canadian market place to ensure the objectives of a fair and independent business valuation for a succession plan.

Typically, the succession plan is completed in isolation of child 2. I would suggest that even though child 2 is not taking over the business, that he or she participates in the succession plan, as their interest lies in a fair allocation of business value to the parents' estate.

All Stakeholders in the succession plan should ensure the Business Valuator is qualified, experienced, and independent in both fact and appearance. You should understand and assess the Business Valuator's past and future business and personal relationships with all Stakeholders.

I will end my column with a quote from **Virginia Satir**: "Feelings of worth can flourish only in an atmosphere where individual differences are appreciated, mistakes are tolerated, communication is open, and rules are flexible — the kind of atmosphere that is found in a nurturing family." X

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