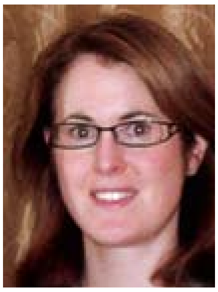

Examining Succession and Tax Planning in Family Businesses in Ireland

Elaine Doyle *Lecturer, University of Limerick*
Dr Naomi Birdthistle *Lecturer, University of Limerick*
Adrian Godwin *Godwin and Co Taxation Consultants*

Introduction

Death and taxes are reputed to be the only guaranteed inevitabilities to face everyone of us at some point. However, research carried out in Ireland indicates that the vast majority of family businesses do not plan adequately for succession.[1,2] According to an article by Karina Corbett,[3] family-owned firms make up 90 percent of the indigenous business sector in Ireland and provide approximately 50 percent of employment. Given that a significant portion of start-up businesses are owner-managed or family-owned, it is a worrying statistic that only 27 percent of family businesses successfully pass to the second generation and 13 percent to the third.[4] Why do so many thriving family businesses fail to succeed after the first generation? It appears that the answer may

1. Birdthistle, N., *Small Family Businesses as Learning Organisations: An Irish Case.* Unpublished PhD, University of Limerick.
2. PricewaterhouseCoopers, Making a Difference: The PricewaterhouseCoopers Family Business Survey 2007/08. Retrieved 16th February, 2008.
3. Corbett, K., *Succession Story* (accessed 3 April 2006 – www.checkout.ie/Feature-print.asp?id=212).
4. Carswell, S., "Surviving the Family Handover", *Sunday Business Post,* 29 February 2004, pp. 17-19.

be as simple as failing to plan adequately for succession.

This article discusses the results of a survey of family businesses which was carried out in order to: investigate the perceived importance of succession planning; to establish whether succession planning is being carried out in Irish family businesses; and to gather data on whether family businesses in Ireland are cognisant of the tax implications of succession – and indeed of the tax reliefs that are available if particular conditions are fulfilled.[5]

The results confirm Naomi Birdthistle's[6] finding that the majority of family businesses do not plan adequately for succession. While owners seem very conscious that various taxes are triggered on succession, they are largely ignorant of any further details and may therefore run the risk of failing to qualify for tax reliefs as a result of lack of care and attention.

These findings are further supported by the research conducted by PricewaterhouseCoopers in 2007.[7] They found that a surprisingly high percentage of family business owners are unaware of the domestic inheritance tax for which their heirs may be liable, even though comprehensive planning aimed at capitalising on opportunities for mitigating the tax burden is considered essential.

While succession planning involves a complex mix of management, financial and psychological issues,[8] we are particularly interested in the tax implications of succession. Specifically, to what degree there is awareness of these implications. While a discussion of the specific taxes triggered on succession, and indeed the reliefs available, is outside the scope of this paper,[9] readers will no doubt be conscious that in order to properly tax plan for succession, the issue must be at the forefront of the owner's mind for a number of years prior to the planned succession date. Birdthistle[10] recommends that succession should be planned for at least five years in advance, with 10 to 15 years in advance being yet more favourable.

The results confirm Naomi Birdthistle's finding that the majority of family businesses do not plan adequately for succession. While owners seem very conscious that various taxes are triggered on succession, they are largely ignorant of any further details and may therefore run the risk of failing to qualify for tax reliefs as a result of lack of care and attention.

Particular care should be taken to plan around the age of the owner/manager, the prior period of ownership of the assets being transferred, and any requirements for the new owner(s) to retain the assets for particular periods after the date of transfer. In order to ensure adequate financial security for the outgoing owner, the level of salary and benefits taken by the owner in the years prior to succession need to be examined to maximise the possibility of making a tax-free termination payment. Adequate pension provision also needs to be built up in a tax efficient manner by making pension contributions in the years prior to the transfer of the business. David Grau, in his article "The Impact of Taxes",[11] summed up the position nicely, saying:

> *"When it comes to taxes, succession isn't always well planned. What you don't know can hurt you, at the worst possible time".*

Research Methods and Results

The aim of this study was to explore the issue of succession and the tax planning issues surrounding it in Irish family businesses. In this context, a survey instrument was designed to gather data on the following:

- The perceptions as to the importance of succession planning.
- Whether family businesses had a succession plan in place.
- Whether the owner was cognisant of the tax implications of succession.
- Whether he/she was aware of the tax reliefs available on succession.

The survey sample consisted of owners of a wide variety of family businesses in Ireland and was administered online. The electronic survey instrument was also disseminated in hard copy to farming businesses that may not utilise electronic communication to the same degree as other businesses. In total, 123 family businesses in Ireland were contacted and asked to complete the survey either online or in hard copy. The authors received 40 usable responses to the survey, giving a 33 percent response rate. Twenty-three of the businesses were classified as sole traders, six as partnerships and eleven as limited companies, representing a good range of business structures.

5. The survey results are part of a longer paper published in *The Irish Business Journal*, (2008) 4(1), 24-371, and are reported here with the kind permission of the journal editors.
6. See 1 above.
7. See 2 above.
8. See the full paper cited at 5 above for a discussion on all of these issues.
9. See the full paper cited at 5 above for an outline of the taxes triggered on succession and the reliefs that may be available.
10. See 1 above.
11. Grau, D. S., "The Impact of Taxes", *Financial Planning*, January 2007, 69-70, 100.

Research Findings

Breakdown of sample group

The breakdown of business origin within the sample group was interesting, with 50 percent of respondents having inherited the business from the previous generation, 42 percent having personally founded the business and eight percent having acquired their businesses from external sources. Indeed, one respondent stated that their business was currently being run by the fifth generation of the family, two were being run by the fourth generation and one by the third generation. The fact that half of the respondents were at least second generation business owners is encouraging and exceeds Simon Carswell's[12] reported average, i.e., that only 27 percent of family businesses successfully pass to the second generation, while just 13 percent pass to the third.

The businesses included in our sample ranged from those with no employees, besides the owner (n=8), to one with over 100 employees. The majority (n=24), however, had less than 10 employees (micro family business). A further four employed between 10 and 50 (small family business), and two employed between 50 and 100 employees (large family business). The number of family members involved in the business also ranged widely from one to ten family members, in either a full-time or part-time capacity. These results give a good spread of responses in terms of business size and degree of family involvement, and provide evidence that family businesses in Ireland come in all shapes and sizes.

Succession planning

Seventy five percent of respondents expressed the desire to see a family member succeed them in the family business, which is largely in agreement with Birdthistle's[13] finding of 80 percent. Some 93 percent of respondents either agreed (38 percent), or strongly agreed (55 percent), that planning for succession was important (see Figure 1 below). However, only 43 percent of respondents currently had a succession plan in place. These figures are consistent with the prior studies conducted by Birdthistle[14] and PricewaterhouseCoopers,[15] who found that 41 percent and 40 percent, respectively, of respondents had a succession plan designed. Of the seven owners who plan to hand over the business in the next four years, only five have a succession plan in place. Of those who plan to transfer ownership within five to nine years (n=6), two have not yet planned for succession, whereas many of the respondents who had no formal plans to transfer ownership of the business within the next 15 years already have some sort of succession plan developed.

successor was a key reason (57 percent). Many respondents stated that they had no intention of handing over the business in the short to medium term and therefore did not consider succession a current issue ("I feel I can be in charge for at least another ten years", "I do not intend to share or hand over any part of the management for about five years"). Many admitted that they did not have a definite plan for the future of the business – "Had not been considered until now [i.e., succession]", "Has not been considered as overly important – until discussing this questionnaire", "No idea of future intentions". In some cases the time pressures involved in running the business prevented respondents from focusing on succession. Despite the fact that 57 percent

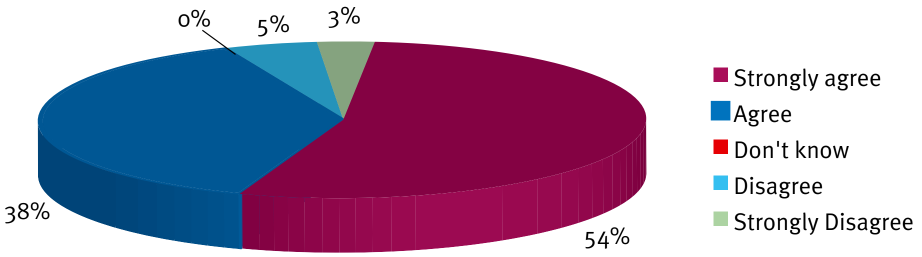

Figure 1: Planning for succession is important

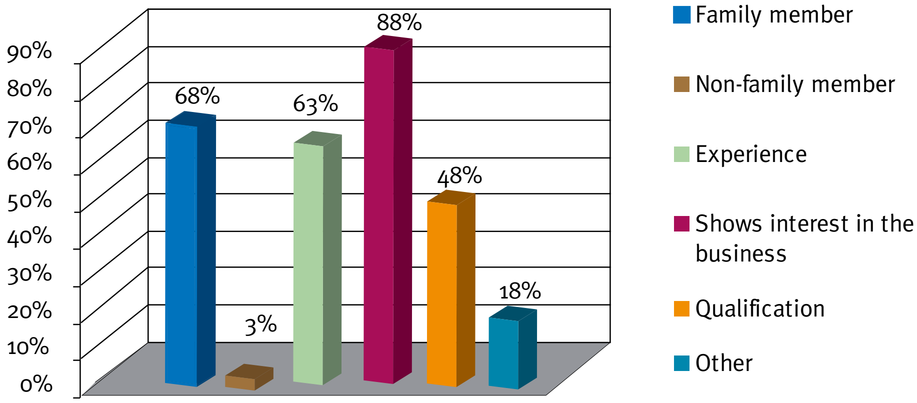

Figure 2: Important criteria for choosing a successor

In cases where no succession plan was in place, various reasons were given for failing to address the issue. Not yet having identified a

of respondents had not selected a successor, 26 percent of these respondents stated that their successor would be a family member.

12. See 4 above.
13. See 1 above.
14. See 1 above.
15. See 2 above.

This suggests that either there are a number of potential successors within the family but one has not yet been chosen, or that potential successors are still too young to have expressed the attitude or desire to take over the business. Furthermore, 70 percent of respondents considered that being a family member was one of the primary criteria necessary for their successor (see Figure 2 below). This factor was considered to be more important than were experience (identified as important by 64 percent of respondents) and qualifications (considered important by 49 percent).

While over half of the respondents did not have any succession plan in place, 85 percent of those did intend to prepare a succession plan some time in the future. The timeframes mentioned ranged from "shortly" or "in the next six months" to "in 15-20 years", with the majority planning to implement a succession plan of some manner within five years. Many stated that they would address the issue within the next 12 months, while others needed to wait until their children were old enough to express a desire to be involved in the business or not – "Children are young and no intention/ideas as to my preferred future plans". Responses indicated that succession is an issue that many have a tendency to avoid, opting instead to focus entirely on the daily pressures of running the business and hoping that the future will take care of itself, perhaps failing to appreciate that sensible succession planning may take 5 to 10 years to plan adequately. To confirm this, one respondent stated: "Under immense time pressure at the moment. I am too busy managing the existing business".

Advantages and disadvantages

Maintaining ownership and control of the business within the family was cited as one of the main advantages of succession planning. Planning was considered to offer peace of mind to the owner and create certainty for successors. "After plan is finished each party knows where they stand (vis-à-vis their role, their wages, etc.)". The "smooth transition of ownership" was seen as one of the rewards to be reaped from succession planning. "Everyone knows in advance and not just waiting to see what will happen in the future, and the person to take over can prepare".

One respondent referred to the need to: "… try to minimise 'blood on the carpet' when a shareholder wishes to exit or passes away." Another was concerned that "the ethos of the business can be continued and the successes can be elaborated." A third wanted assurance that "all the effort is for the family and the good name will be taken into the future". Many were concerned about minimising potential disputes or "hassle between family members", recognising that the family may also be coping with a bereavement as well as a change in business ownership. The involvement of third party advisers was seen by one respondent as being helpful in term of "reducing emotion". Perhaps predictably, others were specifically concerned with "avoiding the sale of family land".

While many of the respondents did cite tax costs as one of the disadvantages of succession planning, 65 percent of respondents admitted that they were unaware of the tax implications involved.

Interestingly, of the 30 respondents who commented qualitatively on the advantages of succession planning, 53 percent mentioned tax minimisation as a prime advantage of forward planning, with responses such as: "Reduce tax cost and secure our retirement position", "Planned take-over with definitive date and avoidance of tax", "Minimise the tax payable for self on exit and for successor", "Allows planning for taxes payable in future". The fact that tax is triggered by succession seemed clear to most respondents and planning was a means to avoid an excessive taxation burden: "Sets out taxes payable by parents and children – allows structuring of shareholding to facilitate planning".

Respondents also considered that succession planning had distinct disadvantages. The chance that the plans or intentions of the owner might change was one of the primary concerns. Owners feared being tied into rigid plans. For example, some respondents felt that "Once a plan is set in stone it cannot be changed", with others admitting to being "Possibly tied into decisions made". Having to face up to death and the possibility of clashes or misunderstandings within the family were also concerns. One respondent felt that putting a succession plan in place may put "pressure on the successor to continue in the business". A reduction in the inclination for the next generation to work at building its own future was also a concern. A number of the respondents cited the cost of succession as a negative factor associated with the process. These issues are consistent with prior work done in this area.

Tax implications

While many of the respondents did cite tax costs as one of the disadvantages of succession planning, 65 percent of respondents admitted that they were unaware of the tax implications involved. However, of the 35 percent that did consider themselves knowledgeable about tax issues arising, many said that they would be fully dependent on their accountant's advice in this area, which is evident from some of the responses – "My accountant has helped", "As per my tax consultant", "Some idea but would need further help". This suggests that while there is a widely held fear of tax costs in the general sense, the details of the actual tax costs triggered on succession are not properly understood. Over 43 percent claimed that they were aware of the existence of tax reliefs that might be availed of on succession, but admitted that the details were hazy. Respondents seemed most aware of the existence of retirement relief in the context of succession, with seven respondents mentioning this relief specifically.

Two respondents mentioned business relief while one referred to relief from stamp duty.

Interestingly, a number of respondents took the view that any tax that might be triggered on succession was the responsibility of the successor and not really of concern to them per se: "The cost will have to be funded by the successor in whatever way he wishes. He is receiving a valuable asset", "The tax cost must be financed by the successor", "Potential purchaser to pay".

Respondents were asked whether they would consider approaching a specialist tax consultant in the formation of a succession plan. Of the 27 who answered this question, 30 percent would not consider doing so (see Figure 3 below), which seems an extraordinary fact given that respondents did not understand the intricacies of the tax legislation but were broadly aware that there are tax costs involved in succession.

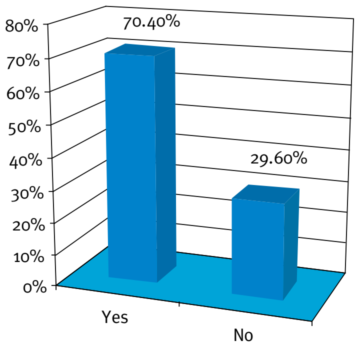

Figure 3: Would you approach a specialist tax consultant to assist in succession planning?

Conclusions

Limitations

Before discussing the results, one needs to acknowledge the restrictions of this study. It is accepted that the scale of the study is limited. The sample size is small and subjects self-selected by voluntarily agreeing to participate in the study. In striving to maintain simplicity, the research instrument may have omitted to capture some of the complexities involved in succession planning. However, this exploration into perceptions of succession planning and, in particular, the appreciation of tax implications and tax risks associated with failure to plan, highlighted some interesting themes.

Profile of respondents

The finding that half of the respondents were at least second generation managers is very encouraging, especially in the context previously referred to – that an average of only 27 percent of family businesses successfully pass to the second generation and 13 percent to the third. However, this finding may also arise from the fact that the sample included several farming businesses, which may be more likely to survive the transfer of ownership through the generations.

The importance of succession planning

Consistent with prior findings, it appears from the results presented here that a high proportion (57.5 percent) of Irish family businesses are reluctant to embrace succession planning – a fact that may be contributing to the low percentage of businesses that pass successfully to the second and third generations. This is despite the fact that, and consistent with Birdthistle's findings,[16] 75 percent of respondents felt it was important that the ownership of the business stayed within the family and 93 percent considered that succession planning was important. The majority of those who did not have any plan in place had not identified a successor, thereby making it harder to plan for the future. However, five respondents who had identified their successor still did not have any formal planning done. Furthermore, 30 percent of those respondents who planned to transfer ownership of the business within the next nine years had no succession plan in place. These findings are worrying and indicate a lack of willingness to face the future and plan properly for succession within an adequate timescale. Advance planning for succession would reduce many of the problems encountered by the new owner/manager.

One respondent suggested that, "The successor needs to have 'life' experience outside of the family business (i.e., travelled, etc.). Qualification is useful but by no means necessary. The successor must want to take over the business and the succession plan should be driven by them". This appears a very sensible view. However, very few of the respondents appeared to approach succession from the perspective of the successor, and instead focused on their own agendas and aspirations for the future of the business. Perhaps a failure to allow the successor the space to personally develop and experience other things outside the family business may be one of the reasons why many family businesses do not survive succession. Many of the respondents stated that their children worked in the business from a very young age, perhaps fostering a resistance to be consumed by the business at a later age: "Family members have worked in the business from a young age", "My family help out with the work and relieve the office staff when required", "Sons have worked in the business from a young age". The comment made by one owner on "The energy, drive, business acumen and vision to develop the business going forward", gives an indication of the qualities often expected of successors. Another considered that his/her successor must possess a "willingness to keep family ethos and name, and to facilitate family members if they are suitable for the position they seek". A third said his/her successor "has to be sensible". "Loyalty" was also considered important. There appears to be a tendency to have very high expectations of potential successors, perhaps indicating why many family businesses do not survive a change in ownership.

One should be encouraged to find that many respondents (70 percent) within nine years of business succession do have some sort of plan in place. However, only a third of those planning to transfer the business within 10 to 15 years had given any thought to succession. Many

16. See 1 above.

respondents expressed the view that it was too early for them to be concerned with succession planning and that they would deal with the issue in time. Timescales mentioned varied from six months to "within the next 10 years". However, most respondents did indicate that they would address the issue within the next five years. One hopes that this is not too late for adequate tax planning to be put in place to ensure that both the current owner and the beneficiaries are protected from tax which could be avoided with proper foresight. However, given Birdthistle's[17] recommendation that succession should ideally be planned for 10 to 15 years in advance in order to avoid some of the common pitfalls, there is a danger that many of our respondents risk succession problems due to their failure to plan adequately.

Death and taxes may remain the two guaranteed inevitabilities, but a little time spent planning for the latter may ensure an easier and more lucrative transition for both the original and new owner on succession.

Taxes and timescales

Owners do seem to be aware that tax costs stem from succession but admitted to not being familiar with the specific taxes triggered and the reliefs available. A basic knowledge of the taxation implications of transferring a family business, or shares in a family company, from one generation to the next is crucial to the success of the succession plan and may prove extremely valuable to the business and the family in terms of avoiding an excessive tax burden. The tax system in Ireland is not designed to maximise the tax taken from the transfer of such entities but there are many pitfalls to watch out for if one is to avoid losing eligibility for the various reliefs available. A lack of understanding of the tax implications of succession may result in the loss of valuable tax reliefs, which will negatively impact on the business when succession finally takes place. As Grau[18] has suggested: "As with good succession planning, understanding the tax implications will change your future for the better" (p.100).

Specialist advice

The reluctance to seek specialist tax advice, as demonstrated by 30 percent of the respondents, gives cause for concern. Many seemed dependent on their accountants for advice in relation to tax issues. While once the remit of the "general practitioner" accountant, tax has grown in complexity and importance and has become a distinct and highly specialised profession in itself. The main taxes and reliefs would be considered as only the basic starting points for effective tax planning and in many cases a thorough review of the tax issues arising in an individual business, together with the personal circumstances of the owner/manager and/or potential successor, may yield further, more sophisticated tax planning opportunities for the various stakeholders concerned, leading to significant tax benefits. It is unlikely that a general practice accountant who provides book-keeping and tax compliance services will be cognisant of the intricate tax issues which may arise on succession, or indeed the current tax structures that may be put in place to mitigate liabilities. Therefore, owner/managers who do not seek specialist advice may be failing to optimise their own tax position and may also be passing unnecessary tax burdens on to the next generation. These tax burdens might not necessarily be immediately evident, but they may arise in the future as a result of ineffective business structuring on succession. In many cases, it is extremely difficult to rectify the unfavourable tax implications triggered by a badly structured transaction once the transaction has been fully implemented.

Maximising the outgoing owner's pension cover and planning for a tax-free termination payment (where possible) are very tax efficient methods of ensuring that the former owner of the business enjoys a comfortable retirement. However, neither of these were mentioned by our respondents. Business owners who only engage with succession planning directly before the business is transferred may not be able to avail of either of these tax efficient methods of funding retirement due to the failure to plan far enough in advance.

Death and taxes may remain the two guaranteed inevitabilities, but a little time spent planning for the latter may ensure an easier and more lucrative transition for both the original and new owner on succession. Sadly, however, it appears that Irish family businesses have not yet embraced the concept of planning early for succession and perhaps presenting the tax profession with an opportunity to assist in this important area of tax planning.

Note:
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17. See 1 above.
18. See 11 above.