Legacy building for family businesses

JULIE WYNNE EXPLAINS WHY CHARITABLE HOLDING FOUNDATIONS ARE AN EFFICIENT TOOL FOR FAMILY BUSINESSES AND FURTHERING SOCIAL IMPACT

AS FAMILY BUSINESSES develop beyond the first generation, they are confronted with unique challenges. The new generation may not be interested in pursuing the ventures of their parents, nor may they be suited to the job. The number of family shareholders increases exponentially, generation by generation, raising questions about who will take over the business. Studies state that less than 30 per cent of family businesses survive into the third generation of family ownership. Therefore, the ownership structure of such businesses is a key factor for making sure they endure.

Social impact through charitable activities, in addition to an ownership structure that combines sufficient capital for growth with family control over key business elements, keeps families committed to the business. It promotes a family's values at a time when members of the millennial generation increasingly look for projects aligned with their values, and seek purpose in both their professional and private life.

Charitable holding foundations are an efficient tool for entrepreneurs looking to preserve the family business and mobilise the new generation around a purposeful initiative. They allow the family business to be held by a long-term entity without shareholders, and to dedicate all or part of the profit to charitable causes.

KEY POINTS

WHAT IS THE ISSUE?
Less than 30 per cent of family businesses survive into the third generation of family ownership.

WHAT DOES IT MEAN FOR ME?
Ownership of family businesses by the descendants should be reconsidered, and should involve a holding vehicle that enables the long-term preservation of the group of companies.

WHAT CAN I TAKE AWAY?
Charitable holding foundations combine both social impact and the preservation of the family business.

INTERNATIONAL OVERVIEW

There is a growing interest in holding foundations for family businesses across the globe, with some nations, such as the Nordic countries and Germany, being a step ahead.

According to a study by Prophil,[1] there are more than 1,350 shareholder foundations in Denmark (out of a total of 14,000 foundations), 500–1,000 in Germany (out of more than 20,000), 20 in Switzerland (out of 13,000) and only two in France (out of 2,200).

In Muslim countries, the *wakf*[2] can be used in a similar way to protect wealth from fragmentation, and to serve both the religious and family interests determined by the founder, and the socio-economic interests of society.

According to Professor Steen Thomsen, foundation ownership is a financially sustainable and socially responsive governance model, which could be more widely used around the world.[3] In his research *Industrial Foundations as Long-Term Owners*,[4] he establishes that foundation ownership is highly stable compared to other ownership structures: foundation-owned companies have conservative capital structures with low financial leverage and score higher on an index of long-termism in finance, investment and employment. They survive longer.

Bringing philanthropy into the family business through its ownership, but also through its corporate philanthropy and corporate social responsibility initiatives, also has a positive impact on employees, customers and suppliers in terms of retention and sense of purpose.

In line with the purpose of charitable holding foundations, but extending it to other vehicles, Purpose Network[5] has introduced the concept of 'steward-ownership', whereby a company is controlled by autonomous steward-owners who have the best interests of the company at heart and are not incentivised to purely optimise financial performance. Governance is executed by stakeholders who are directly involved in running the company, or directly connected to it, rather than by investors or outside influences. Stewards take on entrepreneurial responsibility for the company's values, actions and legacy. In addition, profits are primarily reinvested or donated towards advancing the company's purpose. This is often achieved through a separation of dividend rights from governance rights to eliminate financial incentives and bolster purposeful, intrinsic motivation in the leadership.

SWISS PERSPECTIVES

Under Swiss law, a foundation consists of the endowment of assets for a particular purpose.[6] The articles of association and internal regulations of a foundation allow for great flexibility in terms of its organisation.

Holding foundations, also called shareholder foundations (*Holdingstiftung, fondation actionnaire*), are foundations holding a significant stake in a corporation that operates a commercial business.

As the founder has significant freedom to determine the purpose of the foundation, which can be for the public benefit, solely private or mixed purpose, there are various types of holding foundations in Switzerland:

CHARITABLE FOUNDATIONS

Charitable foundations serve a public benefit, e.g. humanitarian, health-oriented, ecological, educational, scientific or cultural purposes. They can apply for a tax exemption based on their public-benefit purpose. For example, if the foundation is being dissolved, the assets will be allotted to a tax-exempt entity pursuing a similar public-benefit purpose. The assets cannot return to the founders, their heirs or the board members, nor be used to their own profit.

To be recognised as a 'public benefit', the activities of the foundation must aim exclusively at reaching the public-benefit purpose and, as a rule, the foundation should not undertake any commercial activity unless this activity is ancillary to the public-interest purpose.

A key element to consider with regard to charitable holding foundations is that, according to the guidelines of the Swiss federal tax authority,[7] 'economic purpose' does not qualify as a public benefit. However, investments in companies (even if they amount to more than 50 per cent of the equity in these companies) are not a barrier to a tax exemption if they do not allow the foundation to have an influence on the management of the business of these companies. This is the case in particular when someone else or another entity has the voting rights for decisions in the management of these companies. A clear separation is required between the foundation board and the board of directors of these companies, which are independent from one another (a liaison officer is allowed).

> 'Charitable holding foundations are an efficient tool for entrepreneurs looking to preserve the family business and mobilise the new generation'

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When there is a significant stake in a company, the law provides that the interest for the preservation of the business should be subordinated to the public-benefit purpose. The company must therefore make regular and significant distributions of funds to the foundation.

FAMILY FOUNDATIONS

Less common is the family foundation, which primarily serves to support or provide education to family members who are dependent. To be allowed under Swiss law, the purpose of the family foundation must satisfy strict criteria and the foundation may only pay for the costs of raising, endowing or supporting family members;[8] this list is exhaustive.

Family foundations that grant funds to family members without preconditions for maintenance or leisure purposes are prohibited. The foundation may not serve to ensure a mere financial alimony or higher living standard for the family.

Family foundations cannot apply for tax exemption, as they lack the public-benefit purpose and their circle of beneficiaries is limited.

SWISS LANDMARK DECISION

In the landmark decision of 18 May 2001,[9] the Federal Supreme Court confirmed the legitimacy of corporate foundations pursuing an economic purpose. It confirmed that Swiss law does not provide limitations to the purpose of a foundation: a foundation can therefore, as a purpose, hold a participation in a for-profit company.

BESPOKE SOLUTIONS

Considering the various interests at stake (whether the family members want to be involved in the management of the family business, receive dividends from it or have all the benefit going to the charitable purposes), there are many options. A charitable holding foundation can be the sole shareholder of the family business, or a dual shareholdership between the charitable foundation and a holding by the family can be set up, enabling the family to have a financial interest.

Charitable holding foundations are considered to be a way to support the long-term success of a family business, both in financial terms and in keeping the family committed to carrying on as the owner, while contributing to social and environmental impact.

1 For the full study, see www.fondations-actionnaires.eu **2** An endowment of property for religious or charitable purposes **3** Steen Thomsen, *Foundation Ownership and Firm Performance: A review of the international evidence*, Finance Working Paper No. 556/2018, ed. European Corporate Governance Institute (March 2018) **4** See note 3 **5** www.purpose-economy.org **6** art.80 *Swiss Civil Code* (CC) **7** Federal Tax Administration, *Guidelines on Tax Exemption for Organisations with a Public Benefit Purpose*, 8 July 1994, W95-012F **8** art.335 para.1 CC **9** ATF 127 III 337