

Four Realities of Family Business Succession

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Many entrepreneurs intend to pass the family business to future generations. In considering that goal, there are four important realities that need to be understood:

THE ESTATE TAX IS NOT GOING AWAY. Despite all of the political discussions to the contrary, there is not much chance that the estate tax will be permanently eliminated. Under the 2001 tax bill, the estate tax is only eliminated in the year 2010. Unless the elimination of the estate tax is re-enacted before 2011, on January 1, 2011, the current law is automatically reinstated. The combination of a dwindling surplus, the cost of reforming the Alternative Minimum Tax, and the opposition of states, charities and many Democrats make it extremely unlikely that Congress will vote to continue the elimination.

Instead, clients should anticipate a unified credit somewhere between \$1.5 to \$4.0 million per taxpayer (depending upon who wins the political arguments and how much the surplus can fund). Congress may also provide for a reduction of estate taxes on family farms and businesses that is more workable than the present estate tax business deduction (which expires in 2004).

Given that the estate tax is probably not going to be eliminated, an entrepreneur who intends to pass the business to family members is forced to address the transfer tax cost of such a transfer.

THERE IS NO EQUITY VALUE TO A FAMILY BUSINESS. When an entrepreneur wants to pass his or her business to family members, there is no true equity value to the business, because the equity provides no current benefit to the business owner. The equity creates a current benefit only if the business is sold (i.e., as would occur in a third party buy-out). In fact, the equity value of the business is a liability waiting to happen because of the potential transfer tax liability on the passage of the business to family members.

When the issue is properly addressed, the owner is interested in control of the business and the income and benefits are derived from that control. Using readily available planning approaches (e.g., deferred compensation, partnerships and trusts), the income and control of the business can be separated from its equity, and the equity can be passed at a reduced tax cost to family members using various valuation adjustment techniques (e.g., minority and lack of marketability adjustments).

The retention of the equity value of the business may create a transfer tax liability which could have been reduced or even eliminated. By retaining ownership, the entrepreneur loses the ability to not only discount the present value of the business, but also causes the family to pay estate taxes on the appreciation in the business. For example, assume in 2004 (when the unified credit is \$1.5 million), a married taxpayer has a \$10.0 million company and transfers 36% of the business to a family trust for his descendants. The client dies 15 years later. Such a gift has a number of benefits:

- ! If the minority interest which was transferred was discounted at 45% and the donor's spouse agreed to gift splitting, the donor and his spouse's unified tax credit would cover the entire gift (i.e., \$3.6 million discounted at 45% is worth \$2.0 million - the couple's combined gift unified tax credit). Because of valuation adjustments, even if the business did not grow, the immediate estate tax savings would be as much as \$768,000 (i.e., the \$1.6 million adjustment times the 48% estate rate in 2004).
- ! But what if the business grew at a 10% annual rate? At the end of 15 years, the prior transfer will have moved \$13.7 million out of the donor's estate, saving the family an additional \$4.5 million in estate taxes (i.e., \$10.1 million in appreciation at 45%).
- ! Because the entrepreneur still owns a majority of the business, he or she controls the business and determines how the income and benefits from the business are distributed. The trustees selected by the entrepreneur control the gifted business interest and decide how distributions will be made to family members from the trust. With proper drafting, the business owner may retain the ability to remove the trustees during his or her life, without the trust assets being included in his taxable estate.

With top estate tax brackets at 45-49% (and potentially due nine months after death), the tax burden may make it financially impossible for an entrepreneur to pass the business to family members. The estate tax payment of 45-49% of the value of the business (even when electing tax deferral under IRC section 6166) can result in such significant cash drains that the business cannot survive.

Essentially, federal transfer taxes are a voluntary confiscation tax. With proper planning that confiscation can be minimized or eliminated. The key is having the client recognize that equity is not the same element as control - and control allows the owner to benefit from the income of the business. The thoughtful entrepreneur recognizes this issue and realizes that transferring current equity (and its future appreciation) can reduce the future tax burden on the business, without adversely impacting the owner's income or control. Contrary to the owner's intent, the emotional retention of equity ownership can actually destroy the business.

MANAGING THE BUSINESS. Many entrepreneurs intend to pass their businesses to one or more designated family members who will run their business after the entrepreneur's death or retirement. But because the business is often the largest single asset of the estate, the owner often passes part of the ownership in the business to other family members who are not involved in the business.

During the owner's lifetime the owner may have been able to maintain peace in the family and serve as the "benevolent dictator" of the family business. Unfortunately, this powerful role disappears with the entrepreneur's death or incapacity. Sibling rivalry and other issues begin to come to the fore, particularly between those who operate the business and those who are outside the business.

Almost inevitably, the outsiders feel that the compensation and perks provided to the insiders are "excessive." Outsiders will question the business decisions (e.g., capital

expenditures, hiring and firing of employees, expansion plans) of the insiders even when they know little about the business's needs, operations or competition. Outsiders often believe that the income paid to them should match the compensation paid to the insiders.

Meanwhile, the insiders (who often feel they are working much too hard) resent that their sweat is increasing the equity value of the business interest of the outside family members who are continually asking for more and more income to which they are "not justly entitled". The insiders often fail to see that the outsiders have a right to a return on their "investment" in the business. Many family businesses have paid huge legal fees because of these conflicts and/or have been forced to sell the business to alleviate the problem.

This conflict is inevitable as each family member attempts to direct his or her own financial destiny and feels increasingly unable to do so because of the common business ownership with other family members. This is not a matter of "good" and "bad" family members. It is a matter of increasingly different life goals - a normal part of life.

The solution lies in setting up a structure in the estate plan which assures that those in the business own and control as much of the business as possible, while giving outsiders other assets so that they can effectively control their own financial destiny. Life insurance is often a necessary element of this planning. This planning process traditionally must be done by the entrepreneur during life so the entrepreneur can dictate the terms to family members. Often this process will recognize the contribution to the business of those who have long term involvement by passing a disproportionate part of the business to the insiders.

PASSING ON THE PROBLEM. Many planners view the role of the estate planner as passing as much wealth to the next generation as tax-free as possible. Often a family business is included in the wealth passage. The problem with such an approach is it ignores the inter-generational confiscation of wealth that occurs as each generation grows the family's wealth and then attempts to pass it to the next generation.

A pivotal part of any planning process should be to not only minimize the estate tax hit for the parent's generation, but also for the children's passage of wealth to grandchildren. As a part of this context, clients need to understand that it is possible to separate the control and income of the family business from its equity value and future appreciation. The equity and future appreciation can be passed across successive generations without incurring a transfer tax, while the control and the income benefits are passed to the appropriate family members who are involved in the business. Dynasty trusts can fulfill this purpose. Flexibility in inter-generational transfers can be maintained by using special powers of appointment and by the manner that successor Trustees are selected.

A client who has realized the existence of these four truths will save both himself and his family future heartaches and the potential loss the business to estate taxes or family conflicts.

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