

## Two Realities in Estate Planning for a Business Owner

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*"But in this world nothing can be said to be certain, except death and taxes."*

Benjamin Franklin

In the course of my practice as an estate planning attorney, I have found two consistent certainties in estate planning for businesses which might be added to Mr. Franklin's quote. Both certainties assume that the owner of a closely held family business has family members who will continue to operate the business after the current owner's retirement or death. If the owner instead desires to "cash out" by selling or liquidating the business, these realities cease to be an issue.

First Reality: *"the businesses' equity value is not an asset. Rather it is a liability waiting to happen."* When the business owner intends to pass a business to family members, the equity value provides no significant benefit to the owner. In most cases, when the issue is properly addressed, the owner is interested in control of the entity and its income more than the equity value. Using readily available planning approaches (e.g., deferred compensation, partnerships and trusts), the income and control of the business can be separated from the equity, and then 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).

Because of the federal estate tax and state inheritance taxes, when the owner retains the equity value of the business, the family will bear a tax liability which might have been reduced or even eliminated. By retaining ownership to death, the owner 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 2006, a married taxpayer has a \$7.0 million company. Assume the taxpayer transferred \$3.0 million of the business to a family trust and died 12 years later. Such a gift has a number of benefits:

- X If the minority interest which was transferred was discounted at 35% and the donor's spouse agreed to gift splitting, the donor and his spouse's unified tax credit would cover the entire gift (e.g., \$3.0 million discounted at 35% is worth \$2.0 million - the amount of the couples combined unified tax credit). Because of the valuation discount, even if the business did not grow, the estate tax savings would be approximately \$550,000.
- X But what if the business continued to grow at a 10% annual rate? At the end of 12 years, the prior transfer will have moved \$9.4 million out of the donor's estate, saving the family an additional \$4.0 million (e.g., \$7.4 million in appreciation at 55%).

**Tax History.** The first federal estate tax was imposed on July 1, 1862 as a revenue source for the civil war. It was repealed in 1870 and re-introduced in 1914.

With top estate tax brackets at 55-60% (and due nine months after death), the tax burden may make it financially impossible for an entrepreneur to pass the business to family members. The payment of 55-60% of the value of the business (even when electing tax deferral under IRC section 6166) can result in such significant cash drains on the business that it cannot survive.

The thoughtful entrepreneur recognizes this problem and realizes that transferring current equity (and its related 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 ownership can actually destroy the business.

Second Reality: *"conflicts are inevitable between operators of the family business and family members who are outsiders."* Many entrepreneurs intend to pass down their businesses to one or more designated individuals

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 may also pass ownership in the business to other family members.

During the owner's lifetime the owner has been able to make sure that there is 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 then 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) of the insiders even when they know little about the business's 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 value of the business interest of the outside family members who are continually asking for more and more income to which they are not "reasonably 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 inordinate 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 business owner attempts to direct his or her own financial destiny and feels increasingly unable to do so because of the common 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.

<p><b>Tax History.</b> The top estate tax bracket in 1914 was 10%. During world war II, the top rate rose to 77%.</p>
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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.

**Summary.** Many business owners fail to spend enough time to assure the survival of the business they devoted their lives to building. This failure to focus on the survival of a business often results in its destruction from either tax liabilities or inherent family conflicts. With proper advance planning both problems can be avoided.

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