Leaving Your Business in the Hands of Your Family

1. **I'm just leaving the business to my wife when I die. She doesn't really know much about the business, but I figure she can just sell it and get cash. Any problems with my plan?**

   As an owner who plans on their surviving spouse, who doesn't know much about the business, selling it; there are a number of issues to keep in mind. They are as follows:

   1. 20% of businesses are for sale in any given time; and
   2. Only 25% of those for sale actually sell, **This Means 5% Sell** (if your company sales are more than $10,000,000 a year the odds are 50-50); and
   3. The statistics above are based on a successfully operating business **(Is this likely with your spouse in charge?).**
   4. Will the bank or other lender call the loan at your passing? (This routinely happens at the death of a closely held business owner.)
   5. Will buyers or key employees take advantage of your spouse's grief and lack of knowledge?
   6. How will your surviving spouse know what is a reasonable price for the business?
   7. If your spouse is not knowledgeable about the business now, how will your surviving spouse be able to manage the business until it sells?
   8. How will your surviving spouse be able to keep your key employees if the business is going to be sold by her soon after your passing?
   9. How can your business be profitable with a surviving spouse who doesn't know much about the running the business?
   10. Unprofitable businesses generally sell for a fraction of the value of intangible assets, fire sale prices.

   Most business owners who contemplate these factors come to the conclusion that a surviving spouse that is not intimately involved with and very knowledgeable about the business will not realize anywhere close to the real value of the business. The other real issue of this approach is that your surviving spouse may not have enough to maintain a reasonable lifestyle.

2. **I want to leave the business to my children after my wife and I are both gone. Should I just say that in my will, or is there more planning required?**

   There is substantially more planning that is required. The following are some of the significant issues to consider:

   1. Since the planning needs to be done today, the first thing to consider is, has the business borrowed any money from the bank or other lender and will the lender call the loan when you pass away? For most closely held business owners this is more likely than not.
   2. Does the company have funds to pay off the bank? If the company doesn't have the funds do you have enough personal liquidity to pay off the loan immediately?
   3. If the loan is called and there are not sufficient funds to pay it off, will the business be taken over by the bank or other lender?

   So, part of the planning that must be done is to determine how the company will be able to maintain its line of credit without you and your wife to guarantee it.

   Frequently, the only really practical solution to this financial dilemma is to have sufficient life insurance in place to pay off the bank. Life insurance on your life that is owned by you increases the size of your taxable estate. If the business owns the life insurance then the death benefit will increase the value of the business for estate tax purposes. Therefore, it becomes important to carefully consider where the insurance is going to be owned and not just the source of the premium dollars to pay for the life insurance. In most cases the best place to have the life insurance will be in an irrevocable trust that has been properly designed to make sure that the life insurance death benefit will not be included for any reason in the value of your estate.

   If your children are active in the business then there needs to be a plan in place to determine how the business will be managed. This includes who will be on the Board of Directors or managers in the case of a limited liability company (LLC). There needs to be a plan in place as to who will manage the day-to-day operations; how they will be compensated and how changes will be made to that compensation in the future. How will it be determined that a child should no longer be working in the business? If the child should no longer work in the business, then can they continue as an owner or will they need to sell their business interest?

   If only one of the children or less than all of the children are active in the business then we have to address all of the foregoing issues even more carefully. For the child or children who are not active in the business you need to plan what compensation they'll receive as passive owners. If the company is a C Corporation, then any dividends it pays will generate a double tax? If it's a C Corporation and doesn't pay dividends, what will the non-active child realize from their ownership interest? If the business is a pass-through entity, like a subchapter S corporation or LLC or partnership, will the business make distributions to the non-active owners? If the business doesn't make distributions, how will the non-active children be able to pay their taxes on the taxable earnings they don't receive?

If none of the children are active in the business, how will the business be managed for them? Generally, the solution to this is to have professional managers, key employees, operate the business. That presents the problem of how do we keep these people in the company? Who will be on the Board of Directors or managers in the case of the LLC? What kind of economic rewards will need to be provided to these key employees so that they'll help make sure the company is as profitable as possible?

Beyond the planning that must be done to make sure that the business continues as a viable entity, it is important to consider the estate tax consequences of passing the business on to the children. If there's insufficient liquidity in the estate to pay the estate taxes and the other costs of the estate settlement then it may be necessary to liquidate the business to pay the taxes and expenses. If the value of your business exceeds 35% the value of your estate then the portion of the estate tax attributable to the business interest can be spread out with interest for up to 15 years. However, your children become responsible for paying the tax and should 50% or more of the business interest be sold or exchanged then the unpaid tax becomes due and payable at that time. To be sure the transfer is successful, all of the above questions must be answered and a plan for the necessary liquidity developed and implemented.

3. **I have three children who I love equally. My two sons work with me in the business, and my daughter is a stay-at-home Mom who has no interest in the business. Since the business is my biggest asset, I was thinking of leaving the business to all three equally – one third ownership to each. Do you see any problems with that plan?**

In our experience we find that most parents want to treat their children fairly and equitably. In the case of family businesses the simple division of the business into equal shares is rarely either fair or equitable. One of the first questions we ask business owners to answer about their children who are actively involved in the business is "Has the child or children who are working in the business already paid for part of the business through 'sweat equity'?" Part of the way of answering this question is the answer to whether the business active children worked greater hours, had greater risk or have been paid less than if they were working for another business? If the answer is yes, then clearly the one third division isn't equitable or fair.

While on paper, the division into thirds seems equal based on the numbers; this fails to take into account the risk attendant to being the owner of a closely held business. There is no ready market for the ownership interest. You can't use it to buy groceries, pay the mortgage or send the kids to college. It only has value to the extent it produces income to the owner. The children who are active in the business become responsible to create whatever value is to be received by all the owners. This generally requires a significant personal investment of time and energy and creativity by the active children in the business. They invariably believe they should be well compensated for that time and energy and the attendant risk.

It's very common that the child who is not actively involved in the business feel that the business active child or children are overcompensated. It's also common that the business active child will begin to resent the inactive owner child for anything they received from the business. Keep in mind that for the business to furnish an inactive child any funds that they can spend the company is required to make distributions. If the company is a C Corporation the corporation will have to pay tax on those dividends. If the business is a pass-through entity (S corporation, LLC or partnership) or if the business only distributes enough cash to cover the taxes on the inactive owners share of earnings, then the inactive owner still has no useful economic benefit from being an owner. Additionally, every dollar distributed from the company reduces the amount of capital available to be invested in the company to assist in its growth. These differences are part of why there are countless families, including my own, that have been irreparably damaged by dividing the family-owned business between active and inactive children.

4. **If I shouldn’t leave part of my business to my non-involved daughter, how do I keep the inheritance equal for all three of my kids?**

If when you say equal inheritance you mean that each child receives an equal dollar value at your passing there are essentially two ways of making that happen. One is if you have non-business assets equal in value to the share of the business then simply provide that the non-active child receives those assets. If those assets are business real estate then we may not want to distribute those to the non-active child, since this still leaves that child somewhat dependent on the success of the business for what they're receiving. However, this is a better approach than having the inactive child receive an ownership interest directly in the business.

Of course, if you have adequate time you can invest a significant portion of your after-tax earnings outside of the business to create an asset to pass on to your noninvolved daughter. For most business owners that's impractical. Generally there is not sufficient after-tax income after your lifestyle expenses to make that kind of additional investment. Even if you are one of those very successful business owners who could make that kind of investment the real problem is you want to treat your children fairly and equitably whenever you pass away. None of us knows how much time we have, therefore, the surest way to make sure that your daughter receives the amount that you want her to have is to have a life insurance policy with a death benefit equal to the value the business that will pass to her. We generally advise our clients that the life insurance should be owned by an irrevocable trust which will keep the death benefits out of the insured's estate and can provide additional important benefits to your daughter.

5. **I don't have any children, and my wife is not involved in the business. So if I die, I'd like to leave the business to my partner. But I still want my wife to get the cash value of my share of the business. How can I ensure that will happen?**

   To make sure that your wife gets the cash value of your share the business, but not your interest in the business, the best thing to do is to have the business pay for a life insurance policy with the death benefit equal to one half the value of the business with your spouses as beneficiary. One of the problems of leaving your ownership interest in the business to your partner at your death is that it may generate an estate tax. That would substantially increase the cost of transferring the business to your partner.

   A more thoughtful solution to this problem is to enter into a buy sell agreement with your partner. The buy sell agreement would provide that at your death your partner would buy your interest from your wife. This is generally a reciprocal arrangement that would require you to do the same for your partner. At your death the value of your business interest, what your partner would pay for it, will be equal to the new stepped-up basis of your business interest (assuming that the step-up at death is the law in 2011 and later). There will be no income tax due because of this approach. This approach also solves the estate tax problem because you can leave an unlimited amount to your wife and there will be no estate tax due if your wife is a U.S. citizen. Even if she's not, there's planning that can be done to get the same result for a noncitizen spouse. The big problem here is where will your partner get all of the cash necessary to pay for your interest for a business that just lost a key person?

   The solution is for there to be a life insurance policy on your life. The death benefit needs to be equal to at least the value of your interest in the business. The death benefit would be used to pay the purchase price of your interest in the business and provide capital so the business can continue to be successful. There are many ways to arrange the ownership of the policy. We generally believe the best way is to have the policy owned by an irrevocable trust so that the proceeds will not be included in either partner's estate or subject to their personal creditors nor will the death benefit increase the value of the business. The buy-sell agreement will, of course, obligate the trustee of the trust to purchase the shares from your wife for the benefit of your partner.

6. **I'd like to retire, and turn over the business to my two boys, but all my money is tied up in that business. Is there some way to ensure a steady retirement income from the business after I leave?**

   There are several ways to ensure that you have a steady retirement income from the business. The first is to sell the business for a price that will allow the boys to make a reasonable living from running the business and still be able to make payments to you. The income that you would receive would of course be dependent upon the boy's ability to successfully run the business.

If you have enough time before you want to retire, one of the best ways to be sure that the business provides you a retirement income is to set up a tax qualified retirement plan. There are number of plans to be considered, 401(k) and profit sharing plans, SEPs, Simple Plans and defined benefit plans. The company can make tax-deductible contributions to the plan on your behalf. Those contributions will grow tax-free during your remaining working years. If you have the right facts and circumstances it is possible that in a very short time, hundreds of thousands of dollars can be accumulated in a defined benefit plan for your retirement. At retirement you can then begin drawing a monthly check from the retirement plan. The amounts that can be contributed are based on number of factors; but for many closely held business owners, the contributions can be in excess of $100,000 a year. Of course they can be much less; the plan design depends upon the salary history of all the employees and of yourself as well as your age and that of your employees. It is very important that you consult with very qualified professionals before implementing any one of these plans.

An alternative to a tax qualified retirement plan is a nonqualified deferred compensation plan. This type of plan can be limited to just yourself. The benefits can be paid in any amount and for any period of time as long as the company has the requisite cash flow to pay those amounts. Here again, you are dependent upon the successful operation of the company for the income that you will receive. However, there are several advantages to this type of plan. One is that the company is not required to set funds aside prior to your retirement (doing so is a good idea though). The plan can be put in place just months before you retire.

The presence of the nonqualified deferred compensation plan can even reduce the value of the company for estate and gift tax purposes. The plan can also reduce the amount that your sons would need to pay for the business if it's determined that they should buy it from you. Properly documented, 100% of all of the payments made to you under the plan would be fully tax-deductible to the company. The payments could continue to your spouse and the value of the payments going to your spouse would not create any estate tax issue. It's important to note that even though this is a non-qualified deferred compensation plan, there are rules established under federal law known as ERISA by both the IRS and Department of Labor that must be followed.

7. **My kids aren’t interested in the business after I’m gone, so I’d like to sell it now and get some retirement income. After I’m gone, is there some way to benefit both my children and my church with the business proceeds?**

   The approach that works best with the objectives of receiving retirement income, providing some benefit to your children and your church is to contribute some or all of your ownership interest in the business to a charitable remainder trust (CRT). You'll receive an income tax deduction for the present value of what will ultimately pass to the church at the last to die of you and your spouse. The CRT can sell the business interest and the trust will pay no income tax or capital gains on the sale. You will receive an income stream from the CRT for the remainder of your lifetime or if you choose for a term years. You create an irrevocable trust and use a portion of the income from the CRT to make gifts each year to the trust. The trust uses the annual gifts to buy a life insurance policy on your life or on the lives of yourself and your spouse. After you're gone the church will receive whatever is in the CRT and your children will receive the death benefit from the life insurance policy held by the irrevocable trust.

   A variation of the above approach would be to sell a portion or all of the business to your church in exchange for a charitable gift annuity. The gift annuity can furnish you a guaranteed income for life. You will receive an income tax deduction for the difference between what you give the church and the value of the annuity as calculated from IRS tables. If you live less than your life expectancy then the church will benefit because they will have paid you less. Here again the excess income generated by the gift annuity can be used to buy life insurance to provide benefits to your children.

   Yet another technique would be to contribute a portion of the business to a charitable lead trust (CLT). A CLT essentially operates in reverse to a CRT. You could receive an income tax deduction for the present value of the income stream payable from the CLT to the charity taking into account what is likely to pass to your children. At the end of the term of the CLT the assets held by the CLT would pass to your children. The CLT would not provide you with any income. You would have to retain enough of the business sale proceeds to provide yourself with the retirement income you need.

8. **I want to sell the business to my kids, but they don’t really have the money to buy me out, plus I don’t want to pay capital gains tax. Are there any solutions to this dilemma?**

   Like most things in business and tax planning there is no perfect solution. The very commonly used solution to avoid capital gains tax on the sale of a business interest is to contribute the stock to a charitable remainder trust (CRT). The CRT can then sell the stock to your kids, to an employee stock ownership plan (ESOP), or even the business itself. The CRT will pay you and your spouse an income until the last of the two of you passes away. When the stock is contributed to the charitable remainder trust you'll receive an income tax deduction. The deduction should be at least 10% of the value of the stock contributed.

Neither you nor the CRT will pay any capital gains tax at the time of the sale. You and your spouse will pay income tax on the CRT distributions. The tax will be a mix of ordinary, short term capital gains, long-term capital gains, tax-free income and principal. The exact mix will depend upon what would be the income in the CRT if it were a taxpaying entity. The basic rule on the taxability of distributions is that the income that would be taxed at the highest rate is always distributed first.

The ESOP as a buyer has some other advantages for your kids. The ESOP can borrow money from the bank and use those funds to acquire your stock. The company can make tax-deductible contributions to the ESOP which is used to repay the bank. This has the advantage for your children in that the entire purchase price will have been tax-deductible to the business. You may want to make a gift of stock to your children or have them purchase a small interest so that some of their ownership interest is held outside of ESOP.

The downside of the ESOP for many business owners is that all of the eligible employees in addition to the children will be sharing in the ownership of the company and the future value to which it may grow. The ESOP will be obligated to purchase the shares of retiring employees and even of those that leave before retiring to the extent that they are vested in this ESOP. There are ongoing administrative costs associated with having an ESOP that are greater than other kinds of retirement plans. One of the advantages to the business of the ESOP is that when properly communicated it will increase the employees interest in the long-term success of the business because they will effectively be owners. Even though they will not be voting the stock held by the ESOP. Since their future retirement benefit is tied to the future value of the company stock allocated to them, many employees act more like owners and intentionally act to increase the company's profitability.

9. I have one “problem child” who has created a lot of trouble for the family and the business. I don’t mind him getting an inheritance, but I want to ensure that he has absolutely no say in how the business is run after I’m gone. How do I make that happen?

The best way to deal with the problem child in the business issues is to not leave the child any ownership interest in the business. You would work with your advisors to arrive at what would be fair and equitable in providing the child with an inheritance. That inheritance would take the form of cash or other estate assets or the proceeds from a life insurance policy insuring you or you and your spouse. If he is left no ownership interest in the business then he can't make trouble in the business or have a voice in how the business is run.

If there are reasons why you want to provide him with some ownership interest in the business, then that interest should be left in an irrevocable trust for his benefit. This would allow him to benefit from the financial success of the business. By having an independent trustee not directed by him that you have selected to hold the business interest you will have effectively precluded him from having any voice in how the company is run.

You indicated that he has also caused problems for the family. If this relates to misuse of money or simply bad judgment about the use of money it is probably wise to have any financial inheritance for him be left and trust. There are any numbers of ways in which the irrevocable trust can be designed to help address the financial concerns. One of the ways it is frequently used is to provide financial incentives through the trust to encourage the type of behavior that you want him to exhibit. The assets in the trust are also protected from his bed financial judgment. This arrangement can help ensure he lives in reasonably comfortable lifestyle - if there are sufficient funds originally to do so. The trust can also provide for rehabilitation services if there are addictive personality issues.

10. What parts of my estate and/or business Exit Plan should I discuss with my family ahead of time? Why?

It is the opinion of the author that you should discuss your entire estate and business Exit Plan with your family prior to its being document and after it has been implemented. This opinion is also shared by The Family Office Exchange, Roy Williams and Vic Preisser of the Williams Group (authors of *Preparing Heirs*, *Philanthropy Heirs and Values* and a study of over 3,250 families who have lost their wealth). It is well known by most families, financial and legal advisors as well as academics that 9 out of 10 families have failed in maintaining family unity and in preserving their assets for more than two generations. This is a universal problem in that every culture has a saying similar to "from shirtsleeves to shirtsleeves in three generations" or "from rice paddy to rice paddy in three generations".

The Family Office Exchange in a recent study learned that the vast majority of respondents blamed poor planning and investments for the loss of family wealth and unity. Just 7% perceived family dynamics as a risk. Yet Williams and Preisser in their study of families that have lost their wealth and family unity found that 60% blamed it on lack of communication and trust among the family and 25% said it was because the heirs were unprepared for their inheritance. Only 3% said it was because of poor planning and poor investment choices.

However, it is very important that the communication of the estate plan and business Exit Plan be communicated in the appropriate environment and manner. The communication must take place in adult to adult fashion. In most families this is very difficult to do between parents, children and grandparents. To be able to accomplish this it may be in the family's best interest to work with a trained facilitator.

At a minimum the suggestions of Buchholtz and Roth in their book, *Creating the High-Performance Team*, should be followed. The suggestions are to create a zone of safety and trust for the communication. This requires following the three P's identified by Buchholtz and Roth, which are **P**ermission to all family members to assert themselves and speak up; **P**rotection in that all family members need to feel safe in asserting themselves; **P**otency, all family members need to feel that their contribution will make a difference. An excellent source of information on this kind of family communication is the heritage Institute in Portland Oregon whose website can be found at the www.theheritageInstitute.com.

If you are unable to find answers to questions you were looking for, please feel free to view "Unanswered Questions of Business Planning" or "Taxes, How Do They Affect My Business When I Sell it or Die?"