



**How to Plan for the Peaceful Passing of Your Family Business from One Generation to the Next**

By: Barry A. Nelson, Esq.

*There will always come a time in the life of the owner of a family-operated business when he must face two equally unpleasant truths; one, that he is not immortal and two, that not all of his heirs are equally interested in or capable of taking over the family business. These issues create a potentially explosive situation. Mixing family and money is never easy. One would have to have the wisdom of Solomon and the patience of Job to make decisions which balance sound financial reasoning along with emotional factors; or one could (and should) seek the advice of a professional. This article is intended to present certain problems and alternative solutions in this unique area of law which mixes estate planning, finance, corporate law and taxes. Obviously, each family and each family business is different, but knowing the questions to ask of yourself, your children, and your attorney now can save a great deal of heartache and financial loss later.*

Many attorneys have observed how the death of the controlling member in a family business can cause deterioration of relationships between surviving family members and enhance sibling rivalries. According to statistics, only about thirty to thirty-five percent of successful family businesses outlive their founders and fewer than twenty percent continue into the third generation. With these two factors in mind, important additional steps should be considered before a traditional estate plan is

formulated for the owner of a family business.

**I. Family Relationships and Goals should be Considered and Analyzed.**

Among the questions to be addressed are the following:

- How many children have an interest in succeeding to the leadership of the family business and do they have the skills to do so?
- Can one family member be selected as president without causing family conflicts (e.g., what would happen if a younger female is more capable than her older brother and both children have aspirations of taking over for Dad?)
- How can family members who are not active in the family business inherit an equal portion of the family estate if the family business is the most substantial family asset?
- Should the spouses of any family members be considered as potential successors to the family business? An old saying suggests that sons-in-law seldom rise above vice-president when blood relatives are in the business. Yet, where no blood relatives are interested in succeeding to the family business, sons-in-law and daughters-in-law may be ideal successors.
- How can a smooth management transition from one generation to the next be implemented and planned for? A smooth transition is only possible if steps are taken while the senior business owner is healthy and active, yet many business owners neglect such planning.

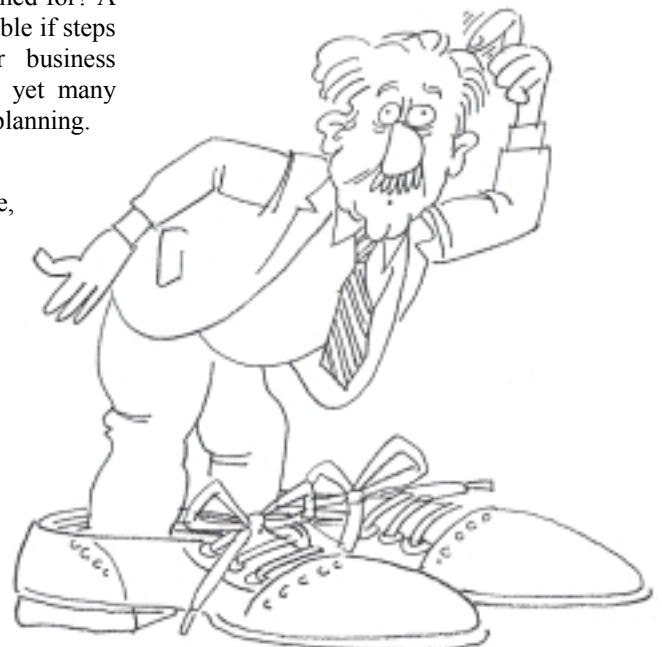
**II. Suits R Us**

Although each case is unique, an example is helpful. Ricky and Lucy (husband and wife) are both 60 years old. Ricky has owned 100% of a successful suit manufacturing corporation (Suits-R-U) since purchasing the stock from his father twenty years ago. Ricky and Lucy have four children. Andrew (age thirty-five), who has been divorced once and recently remarried, has been

active in the family business for about fifteen years since graduating from college with a degree in Art History. Robin (age twenty-eight), is unmarried and has been active in the family business for four years since receiving her MBA from Harvard Business School. Ann (age thirty-two), a successful attorney, and David (age forty), an architect, have chosen professional careers and are not interested in entering the family business. Suits-R-U was recently appraised at \$4 million. The land and offices where Suits-R-U conducts business are owned by Ricky individually and appraised at \$1 million. Ricky and Lucy's other assets are valued at approximately \$2 million.

**A. Ricky Must Select His Successor.**

Ricky must consider whether Andrew and Robin have the ability and desire to succeed him in managing the company. It is common for children to compete for their father's approval and often difficult for one sibling to accept the greater authority of another sibling. Typically, parents may worry about appearing to favor one family member over another, especially, for example, where Ricky may believe that Robin is more qualified for future leadership of Suits-R-U than her older brother who has been involved with the family business for ten years longer.



Although there is no easy solution to the problem of attempting to choose a successor to the business, probably the most logical first step is to have a family meeting to determine how the children feel about the situation. Andrew may surprise everyone by indicating a desire to sell the business upon Ricky's death to pursue his art career. Robin may indicate a desire to marry, raise a family and retire from her career until her children are older. More likely, however, both Andrew and Robin may wish the business to continue and both may believe that they are the logical successor.

### **B. How Should Ricky and Lucy's Assets be Divided?**

Once a decision is made as to how the family will succeed to the business, the family must determine how to divide the estate upon Ricky's death and then upon Lucy's death. Under existing federal estate tax law, Ricky could pass substantially all of his assets to Lucy and incur no estate tax liability upon his death. However, if Ricky decides to leave all of the Suits-R-Us stock to his children upon his death (rather than to Lucy) a substantial estate tax would be incurred upon Ricky's death. Accordingly, tax issues must be considered when determining how the family business should be distributed.

If Andrew and Robin decide that they are interested in succeeding to the family business, it would be appropriate for Ricky to leave them a portion of Suits-R-Us stock upon his death and he should consider making annual gifts to them during his lifetime. Under existing tax law, Ricky can make annual gifts of \$10,000 per child, and \$20,000 if Lucy joins in on such gifts. In addition, both parents can make gifts of \$600,000 during their lifetimes without having to pay current gift tax (assuming they made no prior taxable gifts). This amount is over and above the annual gifting of \$10,000 per person per beneficiary. It should be noted that proposed tax legislation would limit the number of \$10,000 gifts a person can make in any year.

In order to maintain equality in gifts, Ricky must consider whether he should also be making annual gifts to Ann and David. If so, Ricky and Lucy must select

the assets to be given to Ann and David. For example, Ann and David may prefer not to receive stock in Suits-R-Us because they never intend to be active in the business. However, the parents may be unwilling to make gifts of other income-producing assets such as publicly traded securities and certificates of deposit until they pass away.

Ricky must also consider whether he wants to provide an equal distribution of his estate for Ann and David after taking into account the gifts of Suits-R-Us he intends to make to Andrew and Robin. Ricky may consider that the gifts of Suits-R-Us stock to Andrew and Robin are for "services rendered" and thus not to be considered to equalize gifts to the rest of the family. Alternatively, if Andrew and Robin are being well compensated for their services, Ricky may be inclined to provide for an equal overall distribution of his estate so that each of the children receive approximately twenty-five percent of the family wealth (taking into account prior gifts of Suits R Us).

### **C. Equalizing Distributions.**

If Ricky decides to divide his estate equally among his four children, he is faced with several difficult decisions. The company stock comprises more than 50 percent of the family wealth, so if Ricky were to leave the stock to Andrew and Robin, an equitable distribution would be difficult. Andrew and Robin may be unwilling to take their entire inheritance in the form of Suits-R-Us stock because if the corporation fails they would lose their entire inheritance. If Ann and David inherit all of the family real estate they may charge their siblings unreasonably high rent on the property leased to Suits-R-Us, unless this matter is resolved (e.g., by a long-term lease) during Ricky and Lucy's lifetimes.

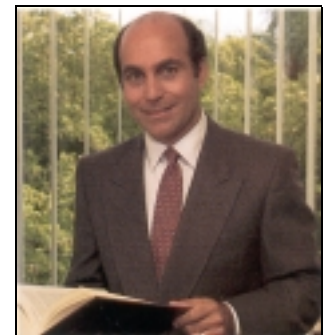
If the children decide to split all the assets equally, a Shareholder's agreement should be prepared to prevent any two children from making decisions that adversely affect their siblings. Comprehensive and honest family discussions are a must.

### **III. Conclusion:**

The questions raised above are not easily answered. Frequently a substantial amount of time and effort is necessary before a lawyer and family can work

together to create the "architectural plans" for the transition of a family business from one generation to the next. There is one certainty, however: failure to plan in this area is a plan to fail. Only by addressing the sensitive issues described above, with the immediate family if possible, can there be any chance of maintaining both a successful business and close and loving family.

A skilled legal representative is a must when planning for the disposition of a family corporation. The attorney should have substantial experience in corporate law, estate planning, trusts and federal income and estate taxation. Frequently the attorney who has served the family over the years as "general counsel" may not be the appropriate person for implementing the plan described above. He may lack the specialized training and/or be too close with the parties to render unbiased advice that will be taken seriously. None of this is pleasant and none of it is easy. Just accepting that proper planning must be done is difficult for many a patriarch. But if in the above example the estate plan is handled timely and well, Lucy and Ricky can relax knowing that both the children they raised and the business they nurtured will continue to thrive.



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