# Estate Planning for Family Business Owners

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ABSTRACT

Aligning the division of assets of a family business owner for estate planning purposes can often be a challenging proposition for both clients and advisors. However, everyone involved may have to recognize that reaching a solution may require both patience and a practical sense that the "perfect is the enemy of the good." The choice of solutions possible offers a great opportunity for the imaginative estate planner to offer lasting value to the family business owner.

Vol. 69, No. 5 | pp. ##-##

This issue of the Journal went to press in August 2015.
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An owner of a family business often faces unique challenges in estate planning not experienced by those who do not have business interests. After all, those with marketable securities, real estate, and retirement accounts can easily direct that assets should be divided into equal shares for their children without much concern as to whether the distribution is in-kind or whether the asset is sold and cash is distributed after the surviving parent dies. The transfer of a business interest at death brings other considerations into the planning process when the next generation has both active and inactive family members.

## Coordination with Lifetime Gifts

The senior owners of the business may initiate a business succession plan by making gifts of a minority interest in the business to one or more of their children who are involved in the business. For the sake of an example to build on, let's suppose that Mr. and Mrs. Client own a business in which their daughter, D, and her husband, H, are active employees. The Clients also have two sons, who are financially self-sufficient and are employed by companies in occupations unrelated to the family business. In short, their sons have no interest in the family business and their daughter expects to acquire the business one day with the expectation that she will be active in it on an ongoing basis. Let's also suppose that Mr. Client owns 51 percent of the business, Mrs. Client owns 39 percent, and they have given 10 percent to D.

Their wills could treat the gift of a 10 percent interest to D as an advancement, as if it is part of her inheritance. In other words, the value of her gift at the time when it was made would be added to the value of the surviving parent's estate at death. The value of the gift would be charged against the share of the estate to which D is entitled. Let's consider a very important point: not all business owners would "charge back" daughter's share. It may be done by a formula in the parents' wills, or, it may not be considered at all. If Mr. and Mrs. Client's wills ignore the gift to their daughter, she would wind up with 10 percent of the business and one-third of the estate. If no formula in the will is employed to charge the gift against D's share, it might seem that D has been favored and the 10 percent gift is a windfall to her. On the other hand, the parents might not see the gift to daughter as a windfall. They may feel that, even though the transfer of shares to her was a gift, legally and tax-wise, she had nonetheless earned the right to own the shares as an active participant in the family business.

It often happens that, in many family businesses, someone like D would not believe that the gift was a windfall or form of "extra" inheritance. She, even more than her parents, might see the gift as a form of "sweat equity," i.e., an asset that she had definitely earned, no matter how it was transferred. That brings us to the heart of the issue that can create dissent within a family. The inactive children may see those who are active as the privileged recipients of family-generated largesse. They may be perceived as catching the nuggets spilling out of the proverbial gold mine that the family business looks like from the outside. In contrast, those who are active within the business may view themselves as miners of the gold mine, working in arduous and occasionally risky circumstances in the hope that gold might be found in sufficient quantity to justify the effort. The truth of the matter might be somewhere in between, but, human nature being what it is, the views of those outside and inside the business might nonetheless be quite different.

Given that, how do you advise the parents as to the best way to develop an estate plan that seems fair to them and to their children who are differently situated in their family business involvement? Let's take a step back from the usual focus this column has on taxes and financial results. When all is said and done, the best outcome of developing an estate plan is for the parents to have peace of mind that they have acted with the right blend of financial responsibility and loving attention. While the children will one day realize the financial benefit of an inheritance, if the message conveyed by the estate plan leaves feathers ruffled, the unfortunate result may be that the financial benefit gets taken for granted, but the hurt feelings don't easily subside.

So, what practical advice can we offer to make sure that the business succession plan can be integrated with the larger estate plan for all family members? A few basic thoughts can be offered. First, when the value of an interest in a family business is considered, perfect mathematical equality may not be achieved. If a bank account consisting of cash is divided, it's pretty easy to come up with equal shares that no one may dispute. The business interest is more difficult to assess, with all due respect to those who might be charged professionally with conducting an appraisal of its value. The thought often expressed is that the estate plan should strive to be equitable to all beneficiaries, and, if equality is the goal, as equal as circumstances may permit. Producing equality may be especially hard if the value of the business is disproportionately large in relation to the other estate assets. That may happen even when the business is not especially great in value, especially if the parents have reinvested its profits to create value in it, rather than withdraw funds to create other assets outside of the business.

## Life Insurance Solutions

Life insurance can offer a solution to family business dilemmas in a variety of circumstances. First, a life policy may serve as an estate equalizer when the

business represents a disproportionately large portion of the parents' estates. For example, without regard to the character of assets, or tax consequences, suppose that a business represents half of the value of an estate and that there are three children, with only one active in the business, as in our example above with D and the two sons. If D winds up with half of the value, say $100x of $200x, then a life insurance policy of $100x for the benefit of the sons extends the inheritable assets to $300x, and each child can receive an equal value of $100x. That's a simple example, not foolproof, maybe practical, maybe not; maybe $100x of insurance isn't affordable, but the Clients shouldn't discard the idea; they may buy what seems affordable, if not $100x. Also, the premise is that D should be the sole owner of the business, but maybe the sons can own a portion, or D can buy a portion from parents now, or after the parents die. The point is that life insurance is uniquely designed to offset an asset imbalance otherwise occurring at death. Like all estate planning, the projection of who ultimately gets which assets and the relative values involved, can only be an estimate. However, having at least some additional insurance may even out the distribution without imposing too much on the financial needs of the parents during their lifetimes. Life insurance may also enable the family to equalize the children's shares, yet still permit D and her brothers to negotiate active and passive ownership of the business, or smoothly determine a buyout arrangement among themselves.

## Life Insurance to Fund Buy-Sell Agreement

Then, too, there may exist the need for a buy-sell agreement funded by life insurance during the parents' lifetimes. In our example, the parents have made a lifetime gift of 10 percent of the business to D. The parents and D may have a buy-sell agreement in which D owns a policy on father (or mother, or both) and agrees to buy the interest of a deceased parent with life insurance proceeds. If more lifetime transfers to D occur, the portion of the proceeds needed for the purchase after death should decrease accordingly. In that case, the face amount of the policy may be reduced. If the disproportion created by the business interest is significant, the insurance proceeds paid by D may be earmarked for the benefit of the surviving parent or her brothers. If business and nonbusiness assets are more balanced, D might reduce the value of the policy at some point and simply pay less for the remaining business interest not yet transferred to her, or, perhaps keep a portion of the proceeds if her obligation is met and the overall estate distribution desired by the parents would permit it.

Aligning the division of assets of a family business owner for estate planning purposes can often be a challenging proposition for both clients and advisors. However, everyone involved may have to recognize that reaching a solution may require both patience and a practical sense that the "perfect is the enemy of the good." The choice of solutions possible offers a great opportunity for the imaginative estate planner to offer lasting value to the family business owner. ■

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