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Succession Planning for the Family-Owned Business—Keepin' it 'All in the Family'

By Eric Wrubel[*]
Warshaw Burstein LLP
New York, NY

The financial repercussions of the worldwide pandemic on family-owned businesses has been widely documented. Of lesser awareness is the impact the Covid-19 virus has had on the future continuity of family-owned businesses. Indeed, both owners and future owners (i.e., descendants) died from the coronavirus rendering succession plans of little use if they had not been initiated. Some family-owned businesses had to scramble to maintain the line of ownership within the family in order for the business to continue operating; this may have led to less than optimal corporate structures being created and/or significant tax liabilities being incurred upon transfer of ownership. And, the professionals typically entrusted with providing such important advice in such planning, attorneys and accountants, were hampered as well in the help they could provide to clients during the pandemic.

As we emerge from the pandemic, and owners contemplate the best structure to transfer the reins of ownership to the next generation, owners should begin the conversations with their financial and legal planners to achieve these ends. This is a multi-party conversation that focuses not only upon minimizing tax liability, fixing the corporate structure, and engaging in estate planning, but also examining the family dynamics as well as acknowledging of the presence of outsiders (i.e., in-laws). In essence, the possibility of an owner becoming divorced from their spouse is an event as important to the family-owned business as any other major event because its impact could be, if not previously contemplated, devastating to the owners. In addition, the nature of the asset held by the family-owned business does not preclude the planning contemplated. Rather, this type of planning is most conducive to family owned businesses where the underlying assets are interests in commercial real estate properties or even multiple dwelling real properties (apartment houses) where owners simply bill and collect. Whether the business is a conglomerate owning multiple farms across many states or even just a business owning the building in which it operates, real estate interests should be protected in the family-owned business.

Several issues require multiple rounds of discussion even before documents can be drawn setting forth the succession plan.

TIMING OF TRANSFER

When will ownership of the family-owned business be passed to the owner's child(ren)? There are many life-cycle events when percentages of ownership or the entire ownership can be transferred (i.e., birth, birthdays, religious events, marriage, and/or owner's death). The timing of such events needs to be thought through very carefully.

MANNER OF TRANSFER

There are multiple pathways to transferring a parent's ownership in a business to their child(ren). Corporate structures and estate planning tools provide a myriad of methodologies than can be employed; the only limits are an advisors creativity and the tax liability that comes along with such a structure. As detailed more fully below, the structure selected may provide one benefit and cause an unintended consequence during a subsequent event — one that could have been predicted.

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This last category involves many issues. Who will be receiving an ownership interest, and what will be

[*] Eric Wrubel is a partner with Warshaw Burstein LLP in New York. Mr. Wrubel's legal practice is devoted to handling complex family and matrimonial matters.

the rights of ownership? Will the plan involve different levels of ownership depending on a child's active involvement in running the business? Will the rights of ownership be documented in the ownership percentages, amounts of distributions, or some other form? It is not atypical for family-owned businesses to be owned by two or more siblings, who then pass ownership to their children resulting in a cousin-owned corporation. This too has its own problems.

In drafting a succession-plan for a family-owned business, parent owners should assume that the future owners will marry and possibly divorce. These two events impact every owner in the family-owned business. Marriage, by its very nature, adds a beneficial owner to the family-owned business as a matter of law. Similarly, an owner's divorce under the right set (or wrong set depending on your point of view) of circumstances could result in essentially a minority shareholder suit forcing the business to buy out the beneficial owner. How likely is such a scenario? VERY!

There are steps a family-owned business can take to bar an in-law from causing such damage. First, the operating agreement/shareholder agreement/ partnership agreement should require all future owners to enter into a prenuptial agreement before marriage which specifically excludes their interests in the family business from being distributed, valued, or deemed marital property subject to distribution in the event of a divorce. Owners may even exact a penalty for an owner's failure to enter into a prenuptial agreement prior to marriage, i.e., a forced sale of their interest to the remaining owners at a fixed price below market value. Similarly, the very same corporate documents should specifically bar an owner's spouse from ever receiving an ownership interest under any circumstances.

A prenuptial agreement is intended to remove the future value of the owner's interest (i.e., at the time of divorce) from the marital asset pool. To do so typically requires the owner to buy-out the future spouse's legal claim to such future value (i.e, its appreciation). This could be a costly exercise since the future value of that ownership interest is unknown. Regardless, some future spouses scoff at signing a prenuptial agreement. This solution is not always available.

If keeping the child's ownership interest free from a claim from a spouse at the time of divorce is an important issue to be included in succession planning, then the manner in which the ownership is transferred between parent and child is the key to solving this problem. One solution is to transfer an ownership interest in a family business from parent to child by gift. Whether the gift is given prior to the child's marriage or during child's marriage, their spouse has no beneficial claim to the child's ownership interest. A gift tax return should be filed to establish irrefutably the transfer was a gift to the child (and not to the child and his then spouse). A gift tax may have to be paid by the donor (i.e., parent), although estate counsel could provide a means to reduce that gift tax liability regardless of its value.

Another solution is a hybrid of a gift and a purchase and sale. In this situation, the parent owner sells to the child an ownership interest in the business; the child gives the parent a promissory note reflecting the purchase price. The parent gifts to the child a sum of money each year equal to the amount necessary to pay off the note in accordance with its terms; the gifted funds should be deposited into an account established solely to receive the gifted funds. The gifted funds are then used exclusively to pay the promissory note to the parent owner. In this situation, a child's spouse would have no claim to a beneficial interest in the ownership interest because the child did not use earnings from the marriage to purchase the ownership interest. It is critical that the transaction and subsequent gifts and repayment of the note be excruciatingly well documented.

The two solutions mentioned hereinabove pertain solely to protecting the underlying ownership interest at the time of transfer between parent and child. If the child who is also a business owner works in the business, that ownership interest may increase in value and a portion of that appreciation may be attributed to the child's activities in the business. Under these circumstances, the increase in value of the child's interest in the family-owned business could be subject to a claim by the spouse during a divorce. Without a prenuptial agreement (as described above), it is nearly impossible to remove the future value of the child owner's interest from a claim by their spouse IF the child owner has worked in the business during the marriage.

If the underlying interest at the time of transfer has been safely removed from the clutches of the in-law, and the only remaining claim is in that interest's increase in value, preemptive measures could be taken at the time of transfer to reduce the amount of appreciation that is subject to the spouse's claim. For instance, a purchase and sale agreement will report the purchase price of the child owner's interest; similarly, a gift tax return will report the value of the interest gifted to the child by the parent at the time of transfer. These values are dispositive. While a family may low-ball the value of the interest transferred between family members to reduce the triggered tax liability, the family may, instead, select a higher value to narrow the appreciation that will be the subject of a spouse's claim at divorce.

In addition, the family-owned business should carefully delineate the differences between compensation

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to owners and distributions of an ownership interest. The former (i.e., compensation/earnings) will be used by the child business owner to support the family, and will be subject to various uses in a divorce action (i.e., support calculations and tracing asset acquisition). The distributions emanating from an ownership interest (if protected at the time of transfer) could be protected from a spouse's claim with some additional actions implemented by a financial advisor.

A plan by its very definition contemplates taking present-day action to countermand the negative impact of future events. Businesses typically focus on earnings, employees, distribution, and raw materials as the source of events impacting the financial health of a business. However, an owner's spouse can wreak equal if not greater havoc on a family-owned business if the owners do not engage in thoughtful succession planning.

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