March 28, 2005

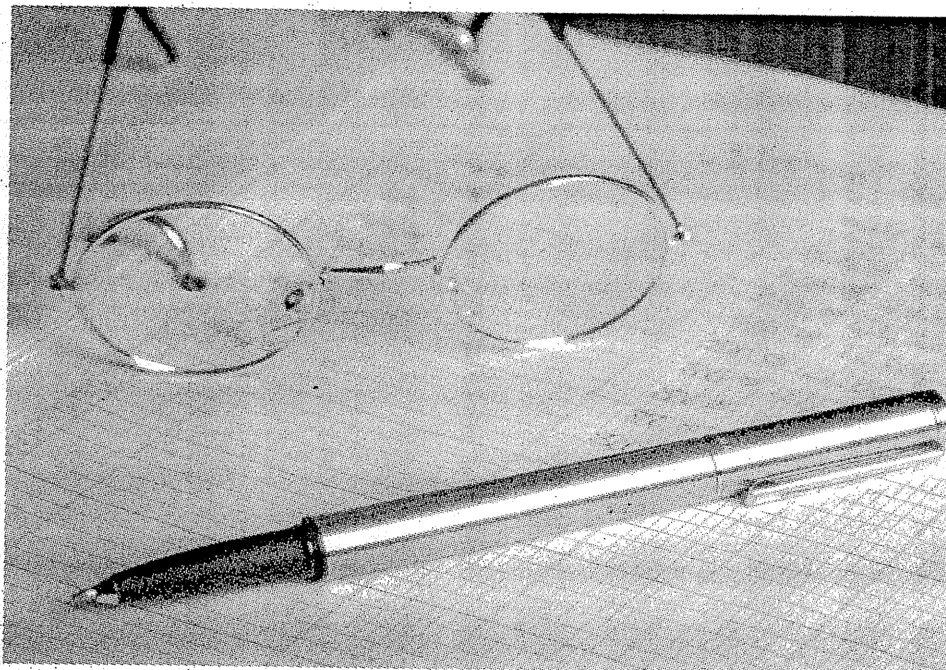
Family Business Planning for the Future

By Michael Hackman, Esq. and Kevin E. Rex, Esq.

We have all heard the saying, "Death and taxes are the only things in life you cannot avoid." Despite this fact, many businesses and entrepreneurs avoid planning for the death or disability of an entrepreneur or owner because such planning does not yield obvious immediate benefits. Moreover, entrepreneurs, by their very nature, are reluctant to give up control. However, in order to preserve the existence of their business beyond their involvement with the business, entrepreneurs should create a succession plan while they are still able to provide meaningful input.

A succession plan primarily deals with the strategy for transferring the management and ownership of the business from one individual (or group) to another and should deal with three related questions. First, who will own the business when the entrepreneur steps aside and/or passes away? Second, who will manage the business? Third, when will the ownership and/or management be transferred? Advance planning will allow for the proper training of successors and minimize the tax burdens which might result at the entrepreneur's death.

The plan should focus on the development, motivation and training of successors who will mange the business. With family businesses, the plan must also deal with the role of family members. For example, what should be done with an unmotivated child or a family member incapable of providing the necessary management skills? When should a family member be promoted? When should the entrepreneur step down? How do all the family members fit into the business, if at all? Should compensation be equitable?



Should outside directors and advisors be utilized? Sadly, there are no easy answers to these questions. As a result, businesses often postpone difficult decisions until it is too late, leading to the demise or forced sale of a business that might have otherwise thrived with proper planning.

Outside of the succession plan, the entrepreneur's estate plan should address how family members not included in the business should be treated, which may include creating nonvoting stock, leaving other assets to such members, or leaving the business real property, which should be held outside of the business in a separate entity, to such members.

Taxes are often one of the primary reasons a business is sold "before its time", as reportedly was the case with the Los Angeles Dodgers. Today, the future of estate taxes is uncertain. While the estate tax exemption is currently $1.5 million, to increase to $2 million in 2006 and $3.5 million in 2009, the tax is repealed in 2010 but reappears again in 2011 unless Congress takes action. If the deceased entrepreneur's interest in the family business is valued in excess of the estate tax exemption and if the marital deduction is unavailable, estate taxes must be paid which could jeopardize the existence of the family business (with an estate tax rate in excess of 45%).

Under current law, holders of family business interests may significantly defer estate taxes; however, a special family business exclusion has been repealed. Additionally, when dealing with family businesses, entrepreneurs can utilize tax free lifetime gifts. For example, there is an $11,000 annual gift tax exclusion ($22,000 for couples). In addition, each person has a $1 million lifetime gift tax exclusion. Moreover, the lifetime transfer of minority interests in a family business may be heavily discounted. There are also a variety of estate planning tools which can be utilized during one's lifetime to minimize potential estate taxes, such as Grantor Retained Interest Trusts and Defective Grantor Trusts. However, most estate planning tools to minimize estate taxes should be implemented over long periods of time. Accordingly, early planning is essential.

In addition to estate and gift taxes, family businesses must confront income tax issues, and sometimes property tax issues. For example, the death of the entrepreneur or his or her spouse (assuming the interest is community property) results in an increase in the income tax basis of the interest, which reduces the potential for capital gains taxes on a sale. The basis increase will be limited if the estate tax is repealed. However, with careful planning, taxes can be minimized and controlled.

For these reasons, entrepreneurs must prepare and periodically revisit succession and estate plans, because like it or not, the third thing which cannot be avoided in today's world is change, and at some point in time, management and ownership must change.

Michael Hackman is a Certified Tax Specialist by the State Board of Legal Specialization.

Kevin E. Rex is a corporate attorney who represents numerous family businesses.

Both are shareholders in the law firm of Lewitt, Hackman, Shapiro, Marshall & Harlan in Encino, California.