American businesses are overwhelmingly family owned. Ninety percent of all American businesses are family owned. Sixty percent of U.S. publicly traded businesses are family controlled and thirty-five percent of Fortune 500 companies are family controlled. According to the Cox Family Enterprise Center, family businesses account for:

- 50% of the Gross Domestic Product
- 60% of all US employment
- 78% of new employment
- 65% of all wages paid

Over three million U.S. family businesses have been created in the last five years. Despite their growth and large impact on the American economy, 65% of family owned businesses fail to survive to the second generation and 86% fail to survive to the third generation.

Many business owners intend to pass the family business to future generations. In considering that goal and achieving that goal, at least seven important realities must be understood by both the planners and clients. This article will discuss those realities.

DEATH AND INCAPACITY WILL OCCUR

“I will continue to continue to pretend that my life will never end…”

~ Paul Simon, Flowers Never Bend with the Rainfall

Clients are not planning for their death or incapacity. According to a recent article, 70% of Americans do not have an estate plan and 21% have estate plans that are out of date. Effectively, 91% of Americans may need a current estate plan.

This lack of planning is reflected in family businesses. In a 2002 Mass Mutual study, 40% of the family businesses surveyed expected a leadership change in the following five years, but 42% of the businesses had not identified a successor to the current CEO. Incredibly, over 20% of the business had done no estate planning for the passage of the family business.

To many clients, having successive root canals without anesthesia is preferable to going through the process of planning for their incapacity and death. Updating the plan, when you know what to expect, could be worse.

“We will all die. The need is apparent. However, Paul Simon may have gotten the perspective of many of our clients correctly: [I will] “...continue to continue to pretend that my life will never end…”

The central question has been how to motivate clients to not only begin the process, but complete and update it periodically. Perhaps a part of the problem is that advisors have started at the wrong beginning. Benjamin Franklin said: “...but in this world nothing can be said to be certain, except death and taxes.” Perhaps we have taken him a bit too literally in how we tell clients to approach estate planning. Is estate planning principally for the dead and the avoidance of their taxes? How many dead people care about their taxes? Motivating people using the fear of something that will not affect them simply does not work. Instead of being for the dead, ESTATE PLANNING SHOULD DESIGNED FOR THE LIVING!

When the focus shifts to the living, the focus is not on mortality and the avoidance of a death tax. Instead, the first focus is on the legacy clients leave behind. Jon Gallo has pointed out that five of the most stressful events a client can face are: death of a child, death of a spouse, death of a sibling, death of a parent and divorce. All these potentials are continually addressed as a part of most estate planning meetings with clients. Mr. Gallo says: “I probably killed off my clients and their children in the first half hour of our meeting.” He is not alone. No wonder clients have such an adverse reaction to estate planning!
Clients are motivated more by the positive legacy they will leave behind, than by the event of death and the taxes that accrue as a result. The significant reduction in the number of Americans subject to estate taxes has at least the potential to re-orient both clients and advisors from believing that the protection and preservation of family assets (e.g. minimizing transfer taxes) is the most important goal of estate planning. The first goal should be **PROTECTING AND PRESERVING THE SURVIVING FAMILY**. 15

Increasingly, clients and planners recognize there is often a misplaced emphasis that focuses both the client and the planner on assets rather than family, on structure and technique over perspective, on tax savings in place of family need. When protecting and preserving the family becomes the beginning point of planning, clients first focus on how to leave a positive impact on their family. Both the client and the planner may be forced to deal with difficult family issues, that both may have preferred to ignore - to the ultimate detriment of the client's family. Saving taxes is important, but it pales in significance to protecting family.

Clients are more likely to do the necessary planning once they realize that the central goal of their planning is not the planning for their death and exit from the business. Rather the goal is the legacy they can leave behind by successfully passing the family business to future generations.

**THE ESTATE TAX IS NOT GOING AWAY**

*The trouble with the tax law of 2001... is that Congress had no thought of its ultimate destination.*

~ Alan Reynolds of the Cato Institute

When the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) passed, most estate planners expected that before 2011, Congress would enact some form of permanent transfer tax legislation to replace the provisions of EGTRRA that died on January 1, 2011. The November 2006 election has put that assumption at serious risk. Increasingly, it is possible that permanent transfer tax legislation will not occur. Among the reasons supporting this possibility are:

- **The Democrats will control Congress at least through 2008.** The House Democratic leadership has not shown a desire to permit permanent transfer tax legislation.

- **Even if the Republicans succeed in taking back control of Congress in the 2008 election, the Democrats will probably retain filibuster control in the Senate and it is unlikely that they will loose that control in the next election.** No one reasonably expects the Republicans to control 60 Senate seats anytime in the near future.

- **Polls indicate most Americans want to eliminate the estate tax.** But, the estate tax has a limited impact on the general population and potential permanent estate tax relief could be traded away for broader-based tax reform, like an overdue reform of the Alternative Minimum Tax.

- **Although estate taxes have made up only 1.1% to 1.3% of the federal revenue during the 1990s, this percentage is expected to grow rapidly as the single wealthiest generation that has ever lived dies and passes trillions of dollars to its heirs.** A study by Boston College estimates that between $41 and 136 trillion will pass by the year 2050.12 Given the concerns that many elderly Americans have taken more out of the Social Security and Medicare than they put into the systems, some in Congress may view the estate tax as a generational repayment of these distributions.

- **Warren Buffett, George Soros, William H. Gates, Sr. and over 300 hundred of America's wealthiest citizens publicly oppose the elimination of the estate tax.** They believe that the primary purpose of the tax should not be the raising of revenue. Instead, it should be to avoid creating a multi-generational class of perpetually wealthy in America. Increasingly, the debate is shifting to the taxation of the super-wealthy as a social issue.18

The unfortunate reality is that the Republicans have had numerous opportunities to enact permanent legislation, but have often chosen political postures (e.g., elimination of the estate tax) instead of compromise legislation that could have adopted permanently higher federal estate tax exemptions and lower rates. Now it appears increasingly possible that the Democrats may decide not to enact any permanent legislation. Three years of large exemptions from 2007-2009 (and an estate tax elimination in 2010) may be of minimal consequence compared to the significant revenue to be raised when the estate exemption drops to $1.0 million and the top tax rate rises to 60%19 in 2011.

State estate taxes may also increase. Roughly half of the states have state estate taxes which are de-coupled from the computation of the federal estate tax. The potential return in 2011 of the federal state estate tax credit is going to create some confusion. First, in “decoupled” states, there will be confusion because state death taxes will not relate directly to the federal estate tax credit and tax computations (e.g., many decoupled states have lower estate exemptions). Second, the other half of the states which have not enacted a new state death tax (and which effectively lost any revenue from the estate tax in 2005), will suddenly see an unexpected return of previously lost revenue. This change will effectively return dollars to the states which had not revoked their state statutes that had coupled their state estate tax to the federal credit. For example, according to one source,20 Florida lost over $1.1 billion in revenue in 2006 from the elimination of the state estate tax credit That lost revenue could now return to the state as an unexpected revenue windfall.
With the partisan wrangling that will come out of the November election, we could be facing a confused, quickly changing landscape: three years of high exemptions and lower rates, one year of no estate tax (and a loss of step-up) and then a return to higher tax rates and lower exemptions. Virtually every single estate plan will have to be reexamined to account for not only the return of the pre-EGTRRA rules, but, perhaps more importantly, the possibility that the client dies in 2010.

Unfortunately, no one has any real idea what Congress is going to do with the transfer tax rules in the next four years. Planning in this time of uncertainty is going to require constant review and updating.

What is certain? There is not a prayer that we will see elimination of the estate tax. At most, we can hope that Congress adopts higher permanent exemptions before 2011. Given that the estate tax is not going to be eliminated, a family business owner who intends to pass the business to family members is forced to address the state and federal transfer tax cost of such a transfer.

**THERE IS NO EQUITY VALUE TO A FAMILY BUSINESS**

For every Tax Problem there is a Solution which is Straightforward, Uncomplicated and Wrong

When an entrepreneur wants to pass his or her business to family members, there is no true equity value to the business. Because the equity will not be reduced to cash (i.e., by a sale of the business), it provides no current benefit to the business owner. In fact, the equity value of the business is a liability waiting to happen because of the potential state and federal transfer tax liabilities on the passage of the business.

When the issue is properly addressed, the owner is interested in control of the business and the income and benefits which are derived from that control. Using readily available planning approaches (e.g., deferred compensation, voting rights, partnerships and trusts), the income and control of the business can be separated from equity, and the equity can be passed at a reduced tax cost to family members using various techniques (e.g., minority and lack of marketability adjustments).

Understanding virtually any aspect of wealth planning is impossible without understanding the basic nature of an asset for planning purposes. Virtually every asset has four primary components which can be appropriately divided in the planning process. These components are:

- **Control** - Often the most important element to the client is the ability to control the asset. For example, even when he makes gifts to family members of company stock, a closely held business owner generally wants to retain control of the business decisions (e.g., to retain control of the payment of income and benefits, or employing family members). A general partner owning only a 2% interest in a family limited partnership may still control the operations of the partnership, but may not have a significant portion of the allocated income, current equity, or future appreciation generated by the partnership's assets. The trustee of a generation skipping trust controls the trust, but is prohibited from using trust assets for his or her personal benefit.

- **Income** - In many cases, the donor wants to retain the right to receive income and other present benefits from the asset. For example, the recipient of a charitable remainder annuity trust has a right to annuity based income, but may not share in the current equity, or future appreciation. In a residential GRIT, the present enjoyment of the residence may be enjoyed by the grantor, while future appreciation is passed to the heirs. A generation skipping trust may provide an income right to a spendthrift child, while restricting his or her ability to control the trust assets.

- **Current Equity** - The current equity value of the asset (i.e., what an owner would receive if the asset were sold) is the third element. While a general partner may control a family limited partnership with a 2% equity share, the vast majority of the partnership's current equity value is normally owned by the limited partners.

- **Future Appreciation** - The last element is the benefit of the future appreciation in the asset's value. With top effective transfer tax rates ranging from 45 in 2007-2009 and 55% in 2011, a major part of tax planning is moving future appreciation out of the estate to avoid an increasing transfer tax burden and resulting liquidity demands on the estate.

- **The proper division of these four basic components lies at the core of virtually all planning strategies. If clients can understand the division of these parts, they may make the difficult decisions that planning requires.**

The retention of the equity value of the business may create a transfer tax liability which could have been reduced or even eliminated. By retaining ownership, the entrepreneur loses the ability to not only discount the present value of the business, but also causes the family to pay estate taxes on the appreciation in the business. For example, assume in 2007 (when the gift tax unified credit is $1.0 million), a married taxpayer has a $10.0 million company and transfers 36% of the business to a family trust for his descendants. The client dies 15 years later. Such a gift has a number of benefits:
If the minority interest which was transferred was discounted at 45% and the donor’s spouse agreed to gift splitting, the couple’s gift tax unified credit would cover the entire gift (i.e., $3.6 million discounted at 45% is worth $2.0 million - the couple's combined gift unified tax credit). Because of valuation adjustments, even if the business did not grow, the immediate estate tax savings would be as much as $720,000. 

But what if the business grew at a 10% annual rate? At the end of 15 years, the prior transfer will have moved $13.7 million out of the donor’s estate.

Because the entrepreneur still owns a majority of the business, he or she controls the business and determines how the income and benefits from the business are distributed. Trustees selected by the entrepreneur may control the gifted business interest and decide how trust distributions will be made to family members. With proper drafting, the business owner and/or heirs may retain the ability to remove the trustees, without the trust assets being included in his taxable estate.

With top estate tax brackets between 45% (starting in 2007) and 60% (potentially after 2010), and the estate tax potentially due nine months after death, the tax burden may make it financially impossible for an entrepreneur to pass the business to family members. The tax payment of 45-60% of the value of the business (even when electing tax deferral under IRC section 6166) can result in such significant cash drains that the business cannot survive.

Essentially, federal transfer taxes are a voluntary confiscation tax. With proper planning the confiscation can be minimized or eliminated. The key is recognizing that equity is not the same element as control - and control allows the owner to benefit from the income of the business. The thoughtful business owner recognizes this difference and realizes that transferring current equity (and its future appreciation) can reduce the future tax burden on the business, without adversely impacting the owner's income or control. Contrary to the owner's intent, the emotional retention of all of the equity ownership can actually destroy the business.

THE INEVITABLE CONFLICT

"Conflict is inevitable, but combat is optional."

~ Max Lucade

Many business owners intend to pass their businesses to one or more designated family members who will run the business after the entrepreneur’s death or retirement. However, because the business is often the largest single asset of the estate, the owner often passes part of the business ownership to other family members who are not involved in the business.

During the owner’s lifetime, the owner may have been able to maintain peace in the family and serve as the “benevolent dictator” of the family business. Unfortunately, this powerful role disappears with the entrepreneur’s death or incapacity. Sibling rivalry, in-law problems and other issues begin to come forward, particularly between those who are operate the business and those who are outside the business.

Almost inevitably, the outsiders feel that the compensation and perks provided to the insiders are “excessive.” Outsiders question the business decisions (e.g., capital expenditures, hiring and firing of employees, expansion plans) of the insiders even when they know little about the business's needs, operations or competition. Outsiders often believe that the income paid to them should match the compensation paid to the insiders.

Meanwhile, the insiders (who often feel they are working too hard) resent that their sweat is increasing the equity value of the outside family members who are continually asking for more and more income to which they are “not justly entitled.” The insiders often fail to see that the outsiders have a right to a return on their “investment” in the business. Many family businesses have paid huge legal fees because of these conflicts and/or have been forced to sell the business to alleviate the problem.

This conflict is inevitable as each family member attempts to direct his or her own financial destiny and feels increasingly unable to do so because of the common business ownership with other family members. This is not a matter of “good” and “bad” family members. It is a matter of increasingly different life goals — a normal part of life.

The solution lies in setting up a structure in the estate plan which assures that those in the business own and control as much of the business as possible, while giving outsiders other assets so that they can effectively control their own financial destiny. Life insurance is often a necessary element of this “equalization planning.” This planning process is best done during the business owner’s life so the entrepreneur can dictate the terms to family members. Often the entrepreneur will recognize the contribution to the business of those who have had long term involvement by passing a greater part of the business to them.
HEIRS IN THE BUSINESS TEND TO INCREASE THEIR OWN BURDENS

“The stakes in conflict do not change. Battle determines who will control the wealth or its equivalent.”

~ Frank Herbert

A son works in the family business. Over 20-30 years the son helps grow the value of the father’s business -- only to share it with his siblings and a not-so-appreciative stepmother. Not only does the development of the parent’s business increase the potential federal and state death taxes, but the son’s participation in the growth of the business must be shared with siblings and other family members. By not addressing the issue before the father’s death, the son will have increased his own burden. Even if a business owner is unwilling to address the value of the child’s long term contribution, children in the business should address the issue.

PASSING ON THE PROBLEM

“Those who have large estates and watchful lawyers will find ways of minimizing these tax burdens.”

~ Robert H. Jackson

Many planners view the role of the estate planner as passing as much wealth to the next generation as tax-free as possible. Often a family business is included in the wealth passage. The problem with such an approach is it ignores the inter-generational tax confiscation of wealth that occurs as each generation grows the family’s wealth and then attempts to pass it to the next generation.

Clients need to understand that it is possible to separate the control and income of the family business from its equity value and future appreciation. The equity and future appreciation can be passed across successive generations without incurring a transfer tax, while the control and the income benefits are passed to the appropriate family members who are involved in the business. Dynasty trusts can fulfill this purpose. Flexibility in inter-generational transfers can be maintained by using special powers of appointment and by the manner that successor Trustees are selected and/or removed.

DIVORCES WILL HAPPEN

“Marriage is often due to lack of judgment, divorce to lack of patience and remarriage to lack of memory.”

Divorce remains an unfortunate reality for many of our clients. In the fall of 2000 Time Magazine ran a lead article that discussed the impact of divorce in America. The article noted that roughly 49% of all U.S. marriages end in divorce. The highest number of divorces occur in the third year of marriage. On average, divorces in second marriages generally occur by the sixth year, while most divorces in first marriages occur by the eighth year.

These statistics are a demographic fact which is often ignored in the planning process. Every plan needs to address the possibility that the client or an heir will face a future divorce. While the discussion may be awkward for the client and advisors, it is an unpleasant prospect which should be strongly addressed.

Divorce can often create unexpected tax results. For example, assume a couple have either owned a business interest together, or part of the business interest is transferred as a result of the divorce. Having an ex-spouse as a partner is not usually a good idea and often the spouse most active in the business wants to buy out the interest of the ex-spouse. If the active business owner has a legal obligation to acquire the business interest of the ex-spouse, but has the business redeem the interest, the business owner, not the ex-spouse may be taxable on the redemption. In Arnes v. U.S., the Ninth Circuit Court of Appeals ruled that a stock redemption as a part of a divorce was taxable to the business owner, not the ex-spouse whose stock was redeemed, because, under the terms of the divorce decree, the business owner had a obligation to redeem the stock interest.

The IRS has issued proposed regulations that address the issue of income taxation resulting from stock redemptions that are created by a divorce. Effectively the proposed regulations provide that if a business owner has an obligation to purchase the stock transferred to a divorcing spouse and the stock is redeemed by the corporation, the business owner will be treated as the seller of the stock.

What is the answer? Careful drafting is critical, including:
• The parties should first evaluate the best after tax result by comparing the relative tax costs to each of them upon divorce.
• The agreement should clearly state how the parties intend to treat any redemption for income tax purposes.
• The agreement should provide that if the couple’s approach is not recognized by the IRS, the party who is not taxed has an obligation of assuming part or all of the tax cost.
• Under no condition should the business owner have any personal obligation to buy the stock or guaranty the company’s obligation to purchase the stock.
• Many state statues provide that a redemption of stock cannot be made if they would result in the corporation being insolvent.

Before entering into an agreement, counsel for both parties should evaluate the impact of a redemption on the business’s financial statement.
• If the business operates as a C Corporation and intends to distribute an appreciated asset, the redemption could result in a taxable cost to the corporation. 27
• If the business operates as a C Corporation the parties should be careful to make sure the transaction is treated as capital gain transaction under IRC section 302 or 303. If the redemption fails to meet the these rules, sales proceeds could be treated as ordinary income (i.e., a dividend) to the deemed seller.

Many parents recognize that their children’s marriages are not stable. Because 49% of the marriages end in divorce, a couple with four children (on average) can expect almost two divorces within their family. In contemplation of this, clients should consider inheritance vehicles which restrict the ability of a divorced spouse to obtain part of the family money. Among the approaches which should be considered are:

• Limiting Control. The single most important aspect of any asset is its control. This is especially true in the context of the divorce of an heir. For example, the last thing most family businesses need is an ex-spouse attempting to gain some control over the family business. In many cases, a client’s spouse or the spouses of his or her heirs hold interest in a family business or may obtain an interest in a family business as a result of divorce. Buy-sell agreements 28 should contemplate this possibility and provide a mechanism that allows other family members to buy-out the divorcing spouse on reasonable terms. If the terms are designed to penalize an ex-spouse, they may be considered unenforceable. Included in those terms should be a long term buy-out to minimize the cash flow problems for the business. Such terms may also reduce the risk that their spouse would want to receive business interests in the divorce.

• Spendthrift Trusts. Spendthrift Trusts have long been a part of the estate planners tools. In recent years as clients increasingly express concern about asset protection and/or spendthrift children, these trusts have become a major part of the estate planning business. Basically a spendthrift trust is any trust which provides for two major restrictions. First, it restricts the ability of any trust beneficiary to assign or otherwise transfer his or her interest in the trust. In most states a trust right is freely assigned by the beneficiary (e.g., as collateral for loans or for other personal purposes). Second, a spendthrift trust restricts the right of creditors of a beneficiary to demand payment of income or principal to satisfy the obligations of the beneficiary. Such trusts also restrict the ability of spouses to put pressure on an heir to put assets into a joint name. Virtually every trust should contain a spendthrift provision. It’s simply good planning.

• Irrevocable Trusts. Virtually all irrevocable trusts should be drafted (and maybe even some revocable trusts), in contemplation of the possibility that one or more of the beneficiaries may get divorced. For example, assume a client creates an irrevocable life insurance trust to pay for estate taxes on the family business. The spouse is named as a beneficiary and co-trustee and is given significant power, such as the right to remove other trustees and a limited power of appointment to reconfigure the trust for the benefit of the couple’s joint heirs. The documents should contemplate the possibility that the insured grantor and the beneficiary/spouse are later divorced. The document could provide that all rights and powers of the spouse, including her right to serve as co-trustee, immediately terminate upon either legal separation or divorce. Few clients want an ex-spouse to financially benefit from their death or be able to control the inheritance of their assets.

Similar issues involve planning for surviving spouses. For example, assume a widow remarries and then dies. There could be claims against the deceased spouse’s assets by the second husband. State statutes may permit the new husband to claim support from the deceased wife’s estate, or assets may have been placed in joint name, with the surviving new husband taking survivorship rights. However, if assets are held in unified credit and Q-Tip trusts, the divorcing spouse can have no property rights to those assets.

• Flexible Drafting. A key element to planning for the potential divorce of the client or the client’s heirs is flexible drafting. 29 Any trust instrument should contemplate the impact of divorce or marriage of beneficiaries on the plan. For example, if a descendant is divorced and the non-descendant parent has custody of minor descendants, the trust should provide for how the ex-spouse is treated. Particularly with irrevocable trusts like Dynasty Trusts, granting a person a “Limited Power of Appointment” 30 can provide significant flexibility to the planning process.

If divorce is such a prevalent issue, it needs to be addressed in the planning process for any family business, particularly when second marriages are already a part of the family dynamic. Although they are not particularly romantic, clients with family businesses and their heirs should be strongly encouraged to sign pre-nuptial agreements before marriage.

There are at least seven uncomfortable and generally inevitable realities that a family with a family business must address in the estate planning process. Clients who realize the existence of these seven truths will reduce future heartaches and avoid the potential loss of the family business to estate taxes and family conflicts.

More planning information can be found at www.scrogginlaw.com.