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Wealth Management & Estate Planning

Family Business Succession:

Creating Your Own Story

Whether addressing the issue of business succession, ownership transference or trust development, local family business owners are showing an increased need to fuse contemporary legal strategies with their family-held visions to better insure the future livelihood of their legacies. In Orange County, appreciation in real estate values has contributed substantially to the success of many family businesses. The following is a hypothetical scenario of a typical Orange County family-owned business and the various estate planning and tax issues — pertinent to many local business owners — which the family addressed through their business development.

The First Steps

A few years after Don and Mary Ellen started their family, they established a **revocable family trust**, and transferred ownership of their growing family business to the trust. Over time, the family business took off.

As the business became more profitable, its holdings grew. Year after year, Don focused on developing opportunities and client relationships.

Eventually, Don and Mary Ellen began buying the real estate connected to their business operations. Thirty-five years later, Don was surprised to find himself walking into his son's office to ask advice about the latest potential real estate acquisition. As he left the meeting, he realized it was time to make sure control of the business passed to his son Jordan, who had become integral to its growth and success. Mary Ellen agreed, but she also wanted to be fair to their daughter Diane, who had never been involved with the business but who had, unlike Jordan, married and brought grandchildren into the family.

Why a Revocable Family Trust? Business owners use revocable family trusts to prevent probate by placing legal title to their assets in the trustee of the family trust. Business owners and their spouses serve as the initial trustees, and their designated successor trustees succeed them upon death or incapacity, thus avoiding the need for a court to transfer title. These trusts also facilitate the application of estate tax credits and provide some level of creditor protection.

Devising the Plan

Don and Mary Ellen made an appointment with their corporate lawyer, and Don was surprised again when his corporate lawyer brought an estate planning lawyer into their meeting. Transferring ownership of the business involved gift and estate tax issues that Don hadn't yet considered. And Mary Ellen's plan to be fair might involve gifting that had nothing to do with the business. Before long, the four of them had worked out a plan.

First, they reorganized the business in a way that split control of the company from ownership of interest in the company.

The **limited partnership** form was chosen over a corporate form to avoid the double tax on income while providing the partners with protection from personal liability for the business operations.

Their corporate lawyer handled the organization of the new partnership and the contribution of their business and real estate to the partnership. She also consulted with the family's accountant to be sure that the new entity would be properly reported to the tax authorities.

Second, Don will establish an irrevocable trust (i.e., **a defective grantor trust**, or DGT) for Jordan's benefit, and Mary Ellen will establish a second trust with identical terms.

Third, Don and Mary Ellen gave of their voting stock to the trustees of their respective DGT.

Limited Partnership – A limited partnership can help business owners avoid dual taxes on income at the corporate level and on dividends at the shareholder level. Additionally, a limited partnership is not subject to the tax imposed by California on an LLC's gross receipts.

Defective Grantor Trusts – The IRS treats a DGT and the person who created it as the same person for income tax purposes, but not for estate tax purposes. Assets that Don properly

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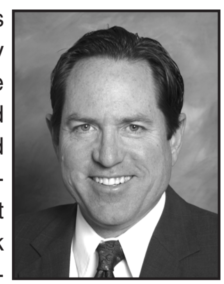

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transfers to his DGT are removed from his estate, but he will still be responsible for the income taxes. The taxes he pays will further reduce his estate for estate tax purposes.

Some tax payers make gifts instead of selling assets to DGTs because they have an ongoing annual gifting program and because they lack considerable assets that would make appropriate gifts.

Because the assets given to DGTs are typically a fraction of the ownership interest in the business and because the partnership agreement can require approval by the existing partners of any new partners, the value of the assets could be **discounted**. This can be important in determining the gift tax implications of the transfer.

Even if no gift taxes are payable, the creator should file a gift tax return to start the statute of limitations on the audit period. The business will need to be appraised formally for these purposes.

Don and Mary Ellen felt confident with this plan except that one goal was not addressed – what should Don and Mary Ellen do to provide for their daughter Diane?

On one hand, the business was, by far, their most valuable asset, and they did not want splinter it or cause management issues by forcing Jordan to consider his sister's best interests, which had never before had any connection to the business. However, there were no other assets with which they could equalize Diane's inheritance.

After consideration, life insurance seemed to be offer the most efficient resolution.

A survivorship policy, purchased through an irrevocable trust will meet many of their objectives. Don and Mary Ellen will make annual gifts to the trust, which may be used to pay the premiums on the policy.

This policy's proceeds can provide a completely independent source of liquidity for an offspring's inheritance while potentially eliminating the concern about a disagreement between siblings.

Also, like the trusts for Jordan, the trust for Diane will continue for the benefit of her children, taking into consideration the generation-skipping tax, a separate tax on transfers to grandchildren of assets in excess of $1.5 million.

Real Estate Will Not Necessarily be Reassessed

There is one issue Don and Mary Ellen must be very careful about. Property tax reassessment of the business's real estate would be very unwelcome.

There will be no reassessment when Don and Mary Ellen transfer the real estate to the partnership, but at any point when more than 50% of the partnership later changes hands, the real estate will be reassessed. This would happen if Jordan received the properties as a result of Don and Mary Ellen's deaths, but the plan outlined above accelerates the transfer of the business and may accelerate the reassessment of real estate as well.

When all of this was accomplished (and it took a number of months), Don and Mary Ellen were happy to know that they had secured the succession of their family business, made arrangements for the support of both their children and their grandchildren and managed the issues of income, estate and gift taxes in ways that minimized their effect on the family.

They also understand that it is important to meet periodically with their advisors, including their lawyers, accountant and life insurance agent, to assess the status of their plan, their business and their family and to ensure that their ultimate goals are met.

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