



*Inspiring and Connecting Thoughtful Giving*

## Toledo Community Foundation

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Since 1973, **Toledo Community Foundation** has provided individuals, families and businesses interested in the well-being of our community with an *efficient, effective, low-cost, professionally managed* mechanism to achieve their charitable goals.

For philanthropists wishing to maximize the impact and life of their charitable gifts, the Foundation provides *resources for thoughtful giving*. Using its expertise and personalized services, **Toledo Community Foundation** helps donors transform their philanthropic impulse to measurable community impact. Beyond the gifting of assets, the Foundation helps donors identify issues of importance to them and *inspires engagement* with community organizations addressing these issues, thereby maximizing the impact of charitable gifts and creating a greater sense of fulfillment.

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## The Family Way

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# Financial Planning

Family businesses are powerhouses for the economy of the United States and have a massive impact on the economy as a whole. Using the broadest definition of family business, the 2000 census showed that 62% of the U. S. workforce was employed in a family business; this translates to some 82 million individuals. The idea of owning your own business and being your own boss is a deeply entrenched part of the American dream.

But family businesses have issues that are very different from those of larger firms, and one of the most important of those issues is figuring out how to take the success of the first generation of entrepreneurs and safeguard and institutionalize it so that the children can inherit a thriving concern. You have to navigate family politics, inheritance law and IRS regulations to accomplish it. It really is different from the kind of estate planning a corporate executive would do, because the value of the inheritance depends on keeping the business alive.

Try to imagine yourself in business with your parents and siblings. Instead of arguing about who is going to have Thanksgiving or who did not give a good Christmas present, you are in business with these people and your entire livelihood and the ongoing family fortune are wound up in these long-term family emotions.

Mom and Dad almost always want to treat kids equally. Many times the nonworking kids look at the business as being an unfair gift to the working child-which, in my opinion, it is not. The business can be a burden or nothing more than a job. Whether the family is working with a financial advisor or an estate lawyer, that person often has

to become the family mediator, and might be the only person in the room who is neutral. This mediator tries to reach a solution that is a compromise all family members can live with, even though no one is completely happy. These situations do not lend themselves to easy mathematical formulas.

## MEET THE FAMILY

Let's take an example where Mom and Dad own a thriving business and they are reaching retirement age. Estate planning has become essential. There are four children: One is a leader in the business, one works part-time in the business, one is a starving artist across the country and one lives nearby and helps out occasionally. Dad and especially Mom are vocal about wanting to divide the assets equally. But what can "equally" mean in this scenario? The essence of family business inheritance is figuring out how to divide assets that do not divide, among children who participate in family life in different ways.

The role of the advisor is to do some comprehensive fact-finding about the family and the business. Sometimes it is really just a job where the kid works hard and gets a paycheck.

As an advisor, you have to figure out how much value there really is in the business-are you shackling one person to 80-hour weeks? You can see where that is headed: If you give equal shares of the business, the nonworking kids will want to get paid the same amount as the working kid, and the working kid says, "Hey, I'm working 80 hours a week and you aren't." And that's where the problems begin.

My objective as an advisor is to get the family to focus on succession while everyone is still alive. In my experience, there is almost always real estate associated with the business, and one approach is to separate the real estate from the business itself. This allows you to split the income streams.

You set up a limited partnership for the real estate while Mom and Dad are alive. The limited partnership then signs a lease with the family members who will inherit the business. The child who inherits control of the business will be running it, but he or she will have to lease the real estate for a reasonable amount. Meanwhile, the nonworking children will be compensated by the rental payments.

I have used this solution a number of times, and it can work very well. If the business alone is not worth as much as the real estate, the working child can also be a partner in the limited partnership.

In fact, many times the working child will get an equal share in the limited partnership because, although the business pays a reasonable salary, it could easily have significantly more risk. In addition, the rent to the limited partnership may actually be soaking up a good deal of the cash flow of the business.

The deal will have to pass an IRS reasonable test for the rent and other factors but, even more important, it has to pass what you might call the family reasonable test. Do all the family members believe this to be fair and

equitable? Does it placate the nonworking children?

If the succession plan is designed far in advance, build in an inflation clause so all parties will feel they have been reasonably compensated. The fights are almost predictable if you do not do this while the first generation is alive.

## NO LEADER

Sometimes there is no clear leader in the second generation, even if all the kids work in the business. This gets to be more complicated. The family will need to set up a binding buy/sell agreement, ideally while everyone is alive. The buy/sell could specify how the kids who do not work in the business can get bought out, or different types or levels of compensation for nonworking children. You have to recapitalize the business and create voting and nonvoting stock.

A buy/sell that includes appropriate amounts of insurance on the lives of the participants can ensure that the buyout is funded and that there will be enough liquidity to effect it should a triggering event occur. Typical provisions of the buyout include who may buy the departing child's share, what events will trigger a buyout and what the price will be.

A note about nonvoting stock: This is where the family can recognize IRS discounts on the value of the business. When a family member is issued nonvoting stock, what does that family member really get? In the eyes of the IRS, not a lot. Nonvoting stock does not have a market, does not have control, and maybe cannot be sold at all. So the IRS values it at a discount.

The point of the buy/sell is that it gives the family rules of engagement for dealing with one another from an ownership perspective. It can be challenging to write this agreement if one child really does not work in the business, but maybe you include a provision that says that child is not entitled to compensation from the business and that the others who work there have the right to buy him or her out. This might not be easily resolved, because one child might not have the right skills for the business.

All around, this can be very complicated to work out. But your chances are much better if the parents are alive and mediating and expressing their own wishes. There is a limit on what a financial advisor, lawyer or both together can do: The kids ultimately have to get along to some degree. You can only do so much.

Life insurance is a common and relatively simple way to get cash to children who are not working in the family business. But it will not work in every circumstance. The insurance might not be realistically affordable. Furthermore, the insurance is also needed for the child who is inheriting the business, to have liquidity to pay inheritance taxes. A valuable business could easily owe, for example, \$5 million in estate taxes—a sum it might not be able to generate.

## S CORPS

Now imagine a successful family business where Mom and Dad are trying to plan but one of them does not want to give up control. Dad will sit with you and nod his head. While he does understand that there are important issues at stake, he is just not going to give up control. The advisor's job now is to figure out a way to pass on the value of the business in a tax-efficient way while retaining current control.

An S corporation is one way to do that. Like a C corporation, an S corporation is a separate legal entity that offers liability protection but is taxed like a partnership, meaning that the income, deductions and tax credits flow through to shareholders annually, regardless of whether distributions are made. This means that income is taxed at the shareholder level and not at the corporate level. There are a number of requirements that determine whether a corporation is eligible to be an S corporation, including having no more than 100 shareholders.

The family business decides to recapitalize as an S corporation and creates voting and nonvoting stock. The children get the nonvoting stock, so although some value has been passed, Mom and Dad retain the voting stock and control. And now you have a way to shift off value to the children, along with the possibility of getting IRS discounts.

## DEFECTIVE TRUSTS

Another technique to consider is the defective grantor trust. Normally income of an irrevocable trust is taxable to the trust or the beneficiaries (in this case, the children). In a grantor trust, however, the trust income is taxed to the creator of the trust, the grantor.

Using a defective grantor trust allows you to freeze the value of the business. For example, I sell the trust \$1 million worth of stock in my company; for income tax purposes, the sale is neutral, meaning that I do not recognize any capital gains on it. The business has essentially been transferred at that price although it may continue to grow. Over the next 10 years, my son, as beneficiary of the trust, will pay me \$1 million using money generated by the business. The value of the business is now frozen at \$1 million. If that company grows to be worth \$3 million, that growth has already been transferred to my son.

This technique is very sophisticated; you need experienced legal counsel and tax advisors to get it done. It is not cheap from an advisory point of view, but it works extremely well for an estate large enough to justify the expense and effort.

Making a sale to a defective grantor trust eliminates one level of taxes: The seller does not pay taxes on the sale. In the right set of circumstances, you have achieved the goal of locking in the value of a business that is appreciating.

## TRUE SUCCESS FACTOR

I enjoy working with entrepreneurs, people who have worked hard and established a successful business. I am always available to sit down with them to go through the issues of passing the business to the children, but I encourage Mom and Dad to talk to their children even before they talk to me. They call to make an appointment, and I say, "Did you talk to the kids?"

There is often this funny reluctance to face the issues with their children. They say, "No, we were kind of waiting to talk to you." And I say, "You have to talk to your children. You have to have a family meeting You have to express directly to them what your wishes are."

Reluctance can come from a wide variety of sources. For one, many people just do not want to face the fact of their own mortality or contemplate losing control of their business. Parents are sometimes afraid their children will be upset with them, or that their children will not value what they have accomplished.

Despite their rational understanding of the tax code and inheritance laws, some parents might find themselves unable to give away their business, their wealth, their control. Like all of us, they procrastinate and see no urgency in making decisions that are important but painful-they would rather defer those to another day, but then they find they have run out of time. They might even have an all-too-human reason for not acting because they do not like the in-laws or some other aspect of the way the children have led their lives.

I have often told this joke about the family business: Dad comes home every night for years and complains about the payroll, the customers, the employees and so on. Then he turns to the children and says, "Someday this will all be yours."

The point is, when you give somebody a business, what are you really giving them? And yet this has been the parents' whole life-it is their legacy. A financial advisor can smooth the transition.

Excerpted from *Wealth Management in the New Economy* by Norbert M. Mindel and Sarah E. Sleight. Used with permission of John Wiley & Sons. Norbert (Norm) Mindel is chief investment officer and principal of Forum Financial in Skokie, IL. Sarah E. Sleight is a Chicago-based freelance writer.

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