Legal Matters®

Estate Planning
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How to transfer a family business to the next generation

Many people who seek estate planning advice are owners of family businesses, and one of their chief concerns is how to pass on the business to the next generation.

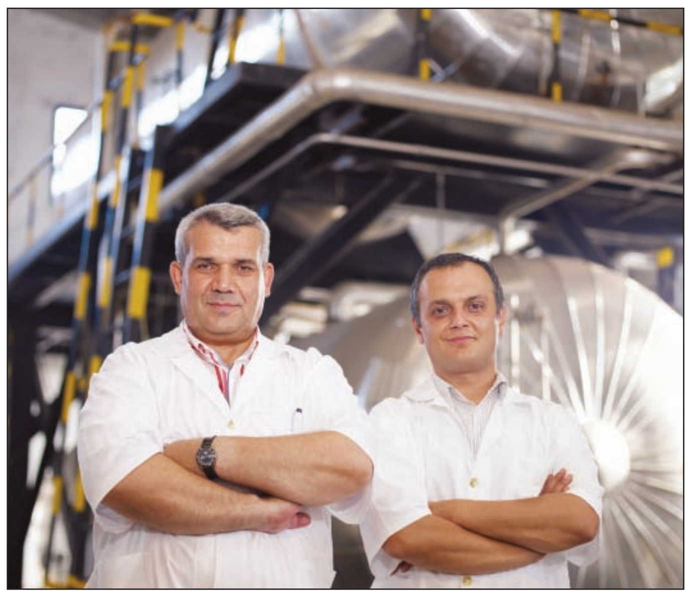
The fact is, there are almost as many ways to transfer a family business as there are family businesses. There's no way to know what's best for you without a thorough discussion of your goals, your family, and your complete financial picture. However, there's no question that dealing with a family business is an essential aspect of planning your estate.

Here's a broad, general look at some of the ways in which a business can be transferred to your children:

• *Put it in your will.* You can give your interest in the business to your children in your will. This is simple, and it allows you to keep complete control of the business for as long as you live.

There are some downsides to this method, however. Some business owners think that their children will benefit from having an ownership stake in the business while they learn to manage it. Some owners worry that as they get older, they might no longer be competent to fully run the company's affairs. In addition, there may be very significant tax advantages to transferring all or part of the business while you're still alive.

• *Give it away now.* You could make a gift to your children of all or part of the business. This might result in your having to pay a gift tax, but at least through the end of 2012, the lifetime gift exclusion is very large, so there might be little or no current gift tax to pay.



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A big advantage to giving away your interest now is that any future appreciation in the value of the business will be excluded from your estate, so it won't be subject to estate tax when you die.

One disadvantage is that, generally, your children's tax basis in

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2012 could be a great time to equalize family gifts

In 2012, there's a wonderful chance to equalize family gifts that have become lopsided over time. But you have to act quickly, because the opportunity evaporates after December 31.

There's a limit on how much money you can give away each year without paying gift tax. For 2012, for instance, you can give any person up to $13,000 without paying tax.

Many people make annual gifts to family members as part of their estate planning. This is a smart idea, but one problem is that over time it can result in unequal gifts to different parts of a family.

For instance, Edna has three children: Alan is single, Stella is married with one child, and Andy is married with four children. Each year Edna gives $13,000 to each of her children, their spouses, and her grandchildren.

But that means that Stella's family gets three times the amount of gifts that Alan gets, and Andy's family gets six times the amount of gifts that Alan gets. Over time, this has resulted in a very large disparity in gifts, and Edna would like to equalize matters a bit.

Of course, Edna could leave more to Alan and Stella in her will, but that might be awkward.


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An option for Edna is to take advantage of the large lifetime gift tax exemption in effect through the end of 2012.

During 2012, a person who hasn't made any prior taxable gifts can give away up to $5.12 million without paying any gift tax. A married couple can give away up to $10.24 million. (These amounts are scheduled to be reduced to $1 million and $2 million in 2013.)

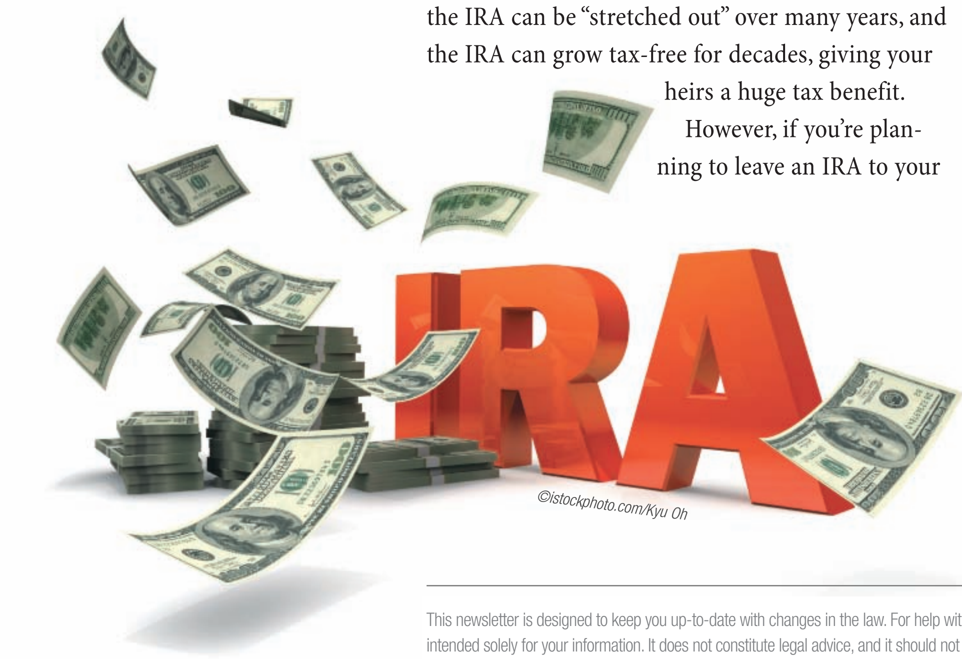
This creates a wonderful opportunity to equalize family gifts that have become lopsided over time. But you have to act quickly, because under the current law, the opportunity evaporates after December 31 of this year.

You should know that the amount of any such gifts will reduce your estate's tax exemption when you die. This is something that needs to be planned for, but it's still usually much better to make gifts now, because any future appreciation in the value of the gifts will be kept out of your estate and won't be subject to the estate tax.

Talk with your heirs about the advantages of inherited IRAs

Leaving an IRA to your children or grandchildren can be a great idea. That's because withdrawals from the IRA can be "stretched out" over many years, and the IRA can grow tax-free for decades, giving your heirs a huge tax benefit.

However, if you're planning to leave an IRA to your heirs, it's important to talk with them now about this strategy – so they understand how to take advantage of it.



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A recent study by the AXA insurance company showed that 87% of children who inherit an IRA from a parent liquidate it within a year of the parent's death.

Of course, in many cases, the children may have an immediate need for the money. But it also seems likely that there are a large number of cases where the children simply don't understand the tax advantages of leaving the assets in the IRA – because the family never had a discussion about it.

This is one of many areas of estate planning where the best-laid plans sometimes go awry if the heirs don't fully understand how the plans are supposed to work.

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the business will be the same as yours (whereas if they inherited their ownership interest through your will, they would get a "stepped-up" basis equal to the value as of the date of death). But there are ways to mitigate this problem.

• *Sell to your children.* Some people want to transfer the ownership of a business while they're still alive, but they also want to continue receiving income from the business. The answer is usually to sell the business to the children. Of course, the children might not have enough assets of their own to buy the business for its fair market value. But that's okay; there are many alternatives.

For instance, you could sell an interest in the business in return for a promissory note. The children would pay off the interest and principal over time using income from the business, and you would have a great deal of flexibility to structure the note in a way that meets your needs.

A variation on the promissory note is a "self-cancelling installment note," which is a type of promissory note that says that if you pass away before the note is paid off in full, any further obligations to you or to your estate are cancelled. This has different tax consequences from a standard promissory note, and it might be worth considering.

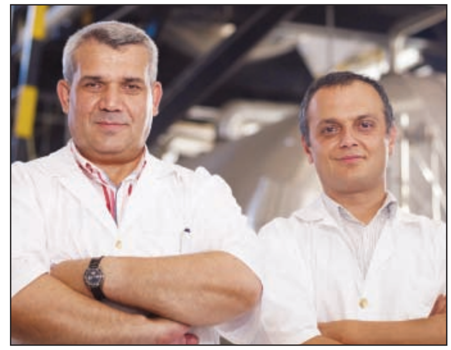
Self-cancelling notes generally must have an interest rate premium in order to avoid gift tax issues, but with interest rates so low today, this might not be a problem.

Other variations include a sale of the business in return for a private annuity, which is like a self-cancelling note but with different annual payments. Also, you can give the business to your children via a "grantor retained annuity trust," in which the trustee makes annuity payments to you for a term of years out of the profits of the business, after which the trust ends and the children become the new owners.

• *Transfer the business to a trust.* You can also sell or give an interest in the business to a trust for your children's benefit. A big advantage of a trust is that it protects the children's interest from creditors and ex-spouses – so the business will be less at risk if the child gets sued or goes through a messy divorce.

It's usually possible to set things up so that the child is a co-trustee who can make business decisions regarding the company, but a second trustee will control distributions of income to the child (to protect against claims from creditors).

Many business owners give or sell business interests to a "grantor trust," in which the owner continues to pay the income tax on the trust assets. Among the advantages of such a trust are that it can avoid capital gains tax on the sale of the trust assets, and it can avoid income tax on interest payments from the trust to the owner. This can be a very powerful method of transferring wealth.



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All of the above ideas can be combined in various ways. For instance, you could arrange a transfer of a business interest that is partly a gift and partly a sale.

And if you're not comfortable giving up control, it's usually possible to split the ownership of the business into voting and non-voting interests, and for now you could transfer only non-voting interests.

Considerations for the children

Often a business owner will have several children, and not all of them will be equally interested in the business. For instance, suppose an owner has three children – Peter, Paul, and Mary – and while Peter and Mary are enthusiastic about the business, Paul has chosen a very different career path.

One option is to give or sell the business to Peter and Mary, but provide for Paul in some other way. For instance, you could leave other assets to Paul in your will, or purchase a life insurance policy that names Paul as the beneficiary.

Once Peter and Mary become part-owners of the company, some thought should be given to what would happen if one of them died or became incapacitated. If Mary dies, and her heirs inherit her share of the business, will that be the best thing for the company? Maybe not. Her heirs might want to sell their share, or might have to do so to pay estate taxes.

A good option is for Mary and Peter to enter into a buy-sell agreement, which says that if one of them dies, the other one (or the business itself) will have the option to buy out that person's interest at some fair price. This purchase can be funded by having life insurance policies on Peter and Mary's lives, with either the other sibling or the business itself as the beneficiary.

As you can see, transferring a family business has many complexities. But the good news is that there are many, many options – and with careful planning, you can choose the ones that make the most sense for your business, your family, and your long-term goals.

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IRS cracks down on family gifts of real estate

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Amazingly, it appears that most people who have given away real estate to family members in recent years have not filed a gift tax return with the IRS.

The IRS requires a gift tax return to be filed any time a person makes a gift to someone other than a spouse of more than the annual exemption amount (which is currently $13,000). So if a person gives a piece of real estate to a child, or sells it to them for $1, or even sells it to them for a price that is more than $13,000 below its actual value, a gift tax return must be filed. That's true for residences, vacation homes, and investment properties.

The IRS has begun digging through state property records looking for such "discount" transfers, to see if the transfers were properly reported. So far, it has focused on 15 states, but it plans to expand into other states. And it has discovered some remarkable figures.

The non-compliance rate in Wisconsin is 50%, the IRS says – but that's better than any of the other states it's checked. "Lowball" transfers were not reported on tax returns about 60% of the time in Connecticut, about 80% of the time in Washington, and about 90% of the time in Florida and Virginia.

In Ohio, the IRS says it has hardly found a single case where a below-market transfer was properly reported.

If you know of anyone who has transferred a home for less than fair market value and hasn't filed a tax return, they should file one as soon as possible. It's much better to file a late return than to not file one at all and have the IRS discover it through an audit.

Many below-market real estate transfers will not trigger any gift tax. That's true as long as the value of the gift was less than the donor's lifetime gift exemption.

However, any gift of more than the annual exclusion amount – again, it's currently $13,000 – can reduce the person's estate tax exclusion. If the IRS finds out about the non-disclosure, it could result in additional estate taxes, gift taxes, interest, and perhaps penalties.

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