Keeping Your FAMILY BUSINESS In The Family

You have worked hard for what you have—you should plan hard to make sure it doesn’t go up in smoke when you are gone. Develop a plan now before it’s too late.

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Robert M. Grant suffered a fatal heart attack Sunday morning while shoveling snow from his driveway. Mr. Grant was the sole owner of Grunt Manufacturing, Inc. He is survived by his wife, Alice, his son, Jack, and his daughters, Julia Grant Kern and Ann Grant.

Two months after this item appeared in the Oakdale Record, Bob Grant’s family met with their attorney and accountant. The faces of the two professionals were grace—the news was to be bad.

Bob Grant had been a successful businessman but he had never planned for the succession of ownership of Grant Manufacturing, Inc. He had inherited all of the company’s stock from his father at a time when values and taxes were low and had transferred none of his holdings while he was alive. The company’s value was yet to be determined, but for planning purposes $3.2 million was being used. Jack, the only family member employed by the company, thought that was on the low side. The attorney listed the other assets and debts that would be included in the estate. Federal and state inheritance taxes would be about $600,000.

Would the family business have to be sold to meet the tax bill? Bob Grant’s CPA was reassuring. Bob’s estate and the company had enough cash and liquid assets to pay all the administration expenses and a portion of the estate and inheritance taxes. The accountant explained that several tax laws help families retain closely held businesses. The purchase of some of Bob Grant’s shares by the company would be permitted at little or no tax cost. Part of the federal estate tax could be paid over a 15-year period with preferential interest charges. All this would help.

The taxes to be paid would directly depend on what the family business was worth. The valuation
Planning for continued family ownership should focus on stock transfers during and after the owner’s life. Life transfers and transfers after death may be used separately or in tandem.

Gifts

If the owner has never made a taxable gift, stock having a value of up to $164,562 may be given tax-free to one person in 1980. Twice that amount can be given tax-free if the owner’s spouse is living and consents to gift-splitting. A gift of $500,000 can be made by the owners alone at a tax cost of $112,280. The total tax is reduced to $54,680 if the gift is split with the owner’s spouse. While a single set of tax rates now applies to lifetime gifts and transfers after death, a tax-free $3,000 may still be given annually to each of an unlimited number of donees. The gift can be increased to $6,000 if it is split between spouses.

A gift program is effective if it is adopted early enough to be continued for a number of years. Its principal advantages are the exclusion of future increases in the stock’s value from the donor’s estate and an income shift to lower tax bracket family members if the family-owner business pays dividends.

When practical, a net gift should be considered. Here, the donor makes the gift subject to the recipient’s agreement to pay the donor’s gift tax. The agreement should be in writing. The value of a net gift, for gift tax purposes, is the fair market value of the property transferred less the gift tax paid by the donee. While this reduces the tax, it also reduces the net value of the gift to the recipient.

Gift programs are seldom the entire answer to the planning problem. Owners of business are understandably reluctant to relinquish control, lose dividend income, and pay a gift tax. Selling the stock may overcome some of these objections.

Stock sales

Stock can be transferred by the owner to other family members by sales. The consideration may be cash, a promissory note, a private annuity, or a combination of all or some of them. An installment sale is permitted. A sale removes the stock from the seller’s estate and replaces it with an asset that has a fixed value—cash or a note. Any increase in the stock’s value after the sale is the buyer’s.

The significant disadvantage of selling stock is the tax consequences.
The gain will be taxed as a capital gain at a maximum rate of 28%. Also, under certain circumstances, a capital gain may be a tax preference item and thus subject to the alternative minimum tax in the year in which it is reported.

The tax burden can be reduced by making an installment sale. This spreads the tax over the years in which the selling price is received. The taxable amount in each year is determined by applying the percentage of profit realized on the entire sale to the payments received during the year. Thus, if a $50,000 gross profit has been made on a $100,000 sale, 50% of each payment is treated as a capital gain. Recent changes in the tax law make installment sales more attractive than ever before. Taxpayers are no longer required to make a formal installment sale election. Nor is there a limit on the amount of proceeds that may be received in the year of sale.

An installment sale gives the seller the benefit of paying the capital gain tax as the sales proceeds are received. If the sales contract does not provide for the payment of interest of at least 9% on unpaid balances, interest at 10% will be imputed by the Internal Revenue Service.

Private Annuity
A private annuity is a planning device that sounds ominous, receives much attention in professional journals, but is infrequently used in practice, perhaps too infrequently. Under the right circumstances, a private annuity is an extremely effective tool for making a lifetime transfer of closely held stock to a family member. Moreover, its use may ultimately result in substantial estate tax savings.

A private annuity constitutes the consideration for the sale of property between two people or between an individual and a corporation. The purchaser agrees to make fixed periodic payments to the seller for the remainder of the seller’s life. If the present value of the projected payments is equal to the stock’s fair market value, no gift is involved. If the present value of the payments is more than the stock’s fair market value, the difference is a taxable gift from the purchaser to the seller. If less, the seller has made a taxable gift to the purchaser.

The principal advantage of this device is that upon the seller’s death his estate has no taxable asset. This is true whether the seller lives beyond or dies short of his life expectancy as measured by applicable mortality tables at the start of the annuity. While the estate tax saving appeals to the seller, the purchaser must be prepared to make payments that are greater than originally projected if the seller lives longer than expected.

A private annuity is taxed very much like an installment sale. Each payment consists of a return of the seller’s original cost which is nontaxable, a gain which is taxed at capital gain rates, and annuity income taxed as ordinary income. However, the purchaser has no tax deduction as no portion of his payments is considered a payment of interest.

Bob Grant could have used this device to his great advantage by making a gift of some of his shares to his children and later selling his remaining shares to the corporation in exchange for a private annuity. This would have left control in his son and daughter’s hands. However, when the corporation redeemed Bob’s remaining shares, he would have had to terminate any interest he had in the corporation. Otherwise, his entire gain on the transaction would be taxed as ordinary income—hardly the result desired.

The ultimate outcome of a transaction in which a private annuity is used is not always certain. But neither is a man’s life span or his financial condition or his family’s needs at the time of his death. One thing is certain; thoughtful consideration must be given to the use of a private annuity when planning for the continuation of a family business.

Recapitalization
Recapitalizing a closely held corporation is often an effective way to transfer control to members of the owner’s family. In the process, stock values may be shifted to accommodate the retiring stockholder’s estate plan. In the usual situation, the controlling shareholder exchanges all or part of his common stock for preferred stock of equal value. If
younger members of the family already own common stock, their interest in the corporation’s residual equity will increase. If they do not hold common stock, the retiring shareholder should make a gift of some of his stock before the recapitalization.

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The preferred stock that the owner receives can be voting stock if the owner wishes to remain active in the business. However, preferred stock that does not carry voting or participation rights has a lower value for estate tax purposes than stock that has those rights.

A successful recapitalization has these affirmative results: (1) the preferred shareholder owns a senior, dividend-paying security which gives him an assured income during his retirement, (2) any increase in the company’s net worth benefits the younger family members who own the common stock, (3) the common stockholders have a greater incentive to increase productivity and profits, (4) major avenues are created for equalizing or redistributing family wealth tax-free, (5) the administration of the retired shareholder’s estate is simplified because valuing preferred stock is easier than valuing closely held common stock.

Had Bob Grant authorized a recapitalization of Grant Manufacturing, he first would have given or sold a few shares of common stock to his children. Then he and those of his children who were not to be active in the business would have exchanged their common stock for preferred. The value of Bob’s shares would have been frozen; any increase in the company’s net worth would have accrued to the common stockholders’ advantage.

A recapitalization has disadvantages. There is the possibility that the profit on a sale of the preferred stock by the former common stockholder will be taxed as ordinary income rather than as a capital gain. This “Section 306 taint” is beyond the scope of this article. Competent tax counsel can suggest ways to avoid this undesirable occurrence.

The real stumbling block is psychological—the owner must agree to a substantial restructuring of his company. A professional appraisal of the company’s value is usually needed. Hard questions must be answered. Who is to control the company? What should the preferred stock’s dividend be? How shall the two classes of stock be spread among the family? What future stock redemption plans should be considered? Should the company seek a ruling from the Internal Revenue Service that the recapitalization is tax-free to all the people involved?

The owner of a closely held business may find it difficult to confront these problems or even to convince himself that he should. The timing may never be right for him. Yet, if recapitalization is the best approach, to postpone may be expensive and foolhardy. It was in Bob Grant’s case.

Buy/sell agreements

A buy/sell agreement is an arrangement between two or more parties obligating one to buy the other’s stock upon the occurrence of a specific event, often the death of one of them. The purpose of the arrangement is to guarantee continued friendly control of the business, give a retired shareholder or a deceased shareholder’s estate a measure of liquidity, and establish the stock’s value for estate tax purposes.

The surviving shareholder has a great deal to gain from the arrangement. He is assured that the deceased stockholder’s estate or heirs will not interfere in the continued operation of the company. Because the purchase price of the stock is fixed, the survivor need not negotiate with executors, heirs, or a bereaved widow who know nothing about the business.

To be able to withstand possible attack, a buy/sell agreement should be negotiated at arm’s length. It can and should be used when warranted but only under the guidance of competent professional advice.
A buy/sell agreement among stockholders is called a cross-purchase agreement. A similar arrangement between a stockholder and his corporation is called a stock redemption agreement. In a stock redemption agreement, the corporation, not a surviving stockholder, is obligated to buy the deceased stockholder’s shares.

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A buy/sell agreement is usually funded with life insurance. This makes it extremely important that the agreement is structured properly. If the corporation owns the policies on the shareholder’s lives, a cross-purchase agreement would be a costly mistake. The proper way to proceed would be with stock redemption agreement. The reason is that if corporate funds are used to finance a stock purchase by the surviving shareholder, the Internal Revenue Service will say that the shareholder has received a dividend on which ordinary income tax rates apply.

Redemptions after death

Anyone planning for the continuation of ownership of a family-owned business should be familiar with those sections of the Internal Revenue Code that permit corporate redemptions after death and that allow the payment of estate taxes to be spread over as many as 15 years.

A closely held corporation may redeem its stock from a deceased stockholder’s estate or heirs with favorable tax consequences even in the absence of a stock redemption agreement. Certain technical requirements must be met, the most substantial of which is that the value of the stock redeemed must be more than 50% of the value of the gross estate. Cash or property equal to the total of all estate and inheritance taxes and deductible funeral and administration expenses may be received from
While mistakes may be made because the course of life is unpredictable, the most serious mistake one can make is to do nothing.

The corporation in exchange for its stock. The redemption proceeds need not be used to pay the taxes and expenses but can be applied to the payment of legacies and debts. This was what the Grant family CPA meant when he said that company funds could be used to give Bob Grant’s estate some liquidity.

Deferment of estate taxes

The tax code provides another way out of the liquidity problem. If the value of the closely held business is more than 65% of the value of the adjusted gross estate, the estate tax attributable to the decedent’s interest in the business may be paid in ten equal annual installments, with the first installment payable five years after the decedent’s death. Interest must be paid on unpaid balances at the rate of 4% of the tax attributable to the first $1 million of the value of the business and at normal rates on the remaining tax. The normal rate is presently set at 12%.

There is another opportunity to defer the payment of estate taxes. If the value of the estate’s interest in the closely held business is either 35% or more of the gross estate or at least 50% of the taxable estate, the estate tax attributable to the business can be paid over ten years. However, there is no five-year deferral of the first installment.

Bob Grant’s executors could couple a redemption of his stock with tax deferral to secure the greatest liquidity possible. Even this course can create problems. If the redemption is spread over several years, annual valuations of the stock probably will be needed. If there are substantial appreciations in value, the capital gains tax that the estate or Bob’s heirs will have to pay could greatly outweigh the benefits of deferring payment of the estate tax. Still, doing nothing could be even more costly.

Don’t delay

You should not confuse present planning for the continuation of your business with immediate relinquishment of control or forced retirement. You have worked hard for what you have—you should plan hard to make sure it doesn’t go up in smoke when you are gone. There are no easy paths. A sound plan cannot be conceived and implemented on a moment’s notice. Think seriously about what you and your family want and need; consider all options; have frank and thorough discussions with your CPA, lawyer, and other professional advisers. Then act on your decisions. Don’t make Bob Grant’s mistake. Don’t wait until it is too late.