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TRANSFERRING THE FAMILY BUSINESS TO CHILDREN

By Carey J. Messina

So you've built a successful business that provides you a good salary and employment for several of your children. Things are going fine, but you are worried about what happens to the business when you retire in a few years, or die. What are you going to do — (i) sell to that "national group" for cash and a nice consulting arrangement; (ii) sell to several loyal employees who have helped grow the business, but have not participated in management; or (iii) transfer the business to the children working in the business.

The first two options may be the easiest ones to accomplish as you are negotiating with third parties. Transferring the business to children can take a lot of twists and turns. The following issues deserve consideration when passing the business to family members:

The Family Feud. Any transfer of the business to less than all of the children has the potential for ill feelings for many years to come. There may always be that underlying feeling that those children who have received the business have received some advantage.

Insurance – the Equalizer. Parents desiring to dispose of their business by gift or bequest to only certain children, may consider life insurance on the parents

lives as a way of "equalizing" assets to the children who do not work in the business. To do this, the parents must consider their insurability, the cost of the insurance and how much in insurance proceeds is necessary to equalize the transfers to the other children. One strategy would be to create a life insurance trust for the children who do not work in the business.

Valuation. It is very important to determine the fair market value of the business for transfer purposes. If the parents are making a transfer for consideration, certainly they want to be compensated appropriately. If the business is sold for less than its fair market value, then the parents may be making a taxable gift for the difference. In making transfers of the business over time by gifting, valuations should always be utilized and discounts should be utilized, if appropriate. Keep in mind that the federal gift tax exemption is currently $1 million per donor. Accordingly, a husband and wife could transfer up to $2 million gift tax free. However, the State of Louisiana still maintains a gift tax exemption of only $30,000.00 per donor with a maximum gift tax rate of three (3%) percent. Both the federal government and Louisiana provide for the $11,000.00 annual exclusion per donee.

Community Property. The family business, whether it be in a sole proprietorship, corporation, L.L.C. or partnership, may be community property. If the plan is to transfer the business interest by way of testamentary bequest, then the transfer will have to take place in two parts, one at the first spouse's death and one at the second spouse's death. Louisiana inheritance taxes have essentially gone away, except in those instances where a succession is not opened timely. This eliminates one layer of transfer taxes. The federal estate tax is still viable. The exemption is currently $1.5 million and is scheduled to go to $2 million on January 1, 2006. Possibly the value of the business would fit within the federal estate tax exemptions of both spouses.

Payment of Federal Estate Taxes in Installments. If the business is passed down to children through testamentary bequest or by intestacy, and federal estate taxes are owed, then consideration must be given to determine whether the value of the business in relation to the entire estate of the deceased, qualifies the estate for installment payments of the federal estate tax. The federal estate tax laws do give some relief in allowing installment payments and allowing a reduced interest rate on the installment payments if certain requirements are met. A review of those installment payment rules is a must in this situation.

Leadership Roles. When considering the transfer of the business to the children, one must also look to the survivability of a business with the children at the helm. Do the children have the appropriate management and people skills to continue a successful business? Are there situations where key employees will seek other employment or possibly establish competing businesses if the owner's children control management? If the parents have sold their interest in the business to the company or to the children, the viability of the business may be critical to the parents being paid out in full.

These are just a few thoughts to consider when transferring the family business to children. This is not an exhaustive list by any means as there are numerous other economic, family, tax and psychological issues that must be weighed.

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