

The Estate Planning Advisor

Estate Planning For the Family Business

By Richard J. Shapiro, J.D.

One of the biggest estate planning challenges is arranging for the transfer of a family business. Given the emotional and tax landmines associated with business succession issues, all too often there is inadequate planning for transferring the family business to the next generation.

Let's look at a common situation: starting from scratch in 1968, the "Murphy's" built up a contracting business ("Murphy Construction") that is worth \$4 million in 2008. Murphy Construction is a corporation, with Mr. and Mrs. Murphy each owning 50% of the stock. They have lived modestly, and have put most of their earnings back into the business. The Murphy's have two children: 42-year-old Tom, who works for Murphy Construction as chief project manager, and 39-year-old Susan, who is a schoolteacher.

The Murphy's would like Tom to eventually own the business, but they are unprepared to give him control today. Tom's shaky marriage is also a concern, and they do not want to have the business fall into their daughter-in-law's hands if Tom and his wife divorce. Since most of their wealth is tied up in the business, the Murphy's are concerned that they will be unable to pass an equivalent inheritance to Susan unless they give her a share of the business, which might impair Tom's ability to effectively run the business after his parents' deaths.

The Murphy's might consider a common approach, with each of them gifting \$12,000 worth of stock annually to Tom utilizing the annual gift tax exemption. But this strategy is not practical for transferring a \$4 million business, and would require costly business valuations at least every few years. If they were to make larger gifts, they will use some of their lifetime \$1 million gift tax exemption, and Tom would also likely suffer from significant capital gains tax exposure for the gifted stock. Also, any stock gifted directly to Tom would be subject to the claims of his creditors, and might also be subject to equitable distribution if Tom and his wife were to ever divorce. Finally, the gifting approach does nothing to provide Susan with an inheritance.

What are some better solutions? Here's one strategy, simplified for purposes of this article: the Murphy's might consider recapitalizing their corporate stock into voting and non-voting shares. The non-voting shares (typically 98% or 99% of the total stock interests) could then be sold to a Grantor Deemed Owner Trust ("GDOT") established by the Murphy's. As payment for the non-voting stock interests, the Murphy's would receive a promissory note. Because of the restrictions imposed on the non-voting shares, as well as their lack of ready marketability, the non-voting shares would typically receive a valuation "discount," often from between 25% to 50% of the underlying value of the corporation's assets. The promissory note payments would be funded with cash flow from the business, with the Murphy's possibly taking a reduced salary so that their total

compensation would be the same as without the note. Upon the Murphy's deaths, the terms of the GDOT would provide that the non-voting stock be allocated to a trust for the benefit of Tom, with Tom being a controlling trustee. The stock would thus be protected against any of Tom's creditors, and would also be protected if Tom and his wife were to ever divorce.

Assuming the Murphy's are insurable, Susan's inheritance could be funded through a joint-and-survivor life insurance policy owned in a life insurance trust. This would allow Susan to receive her equal share, without impacting Tom's autonomy and control over the business.

Many family businesses falter upon the founders' deaths, but it doesn't have to be this way. Once the clients' goals and objectives are thoroughly reviewed and analyzed, many techniques may be considered and implemented to achieve a happy resolution for the family.

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