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Paying it forward

How good communication, planning amongst kin can help to minimize tax bite on family businesses

BY MARTIN DAKS

Gerard Brew is a partner at the law firm McCarter & English LLP, but there are times he seemingly has to function as a psychologist when he works with family business owners on estate tax planning matters.

"People can be focused on tax issues, but must also understand family dynamics," he said. "It's important to listen to what family members are saying about their personal goals too."

Next-generation family business planning can easily spark a lot of friction, he added, since personality, financial and business issues are often a volatile combination. In some cases, a family member may start a business, get divorced and then remarry. "What happens if the business owner has grown kids from the first marriage who could conceivably run it, but the second spouse wants liquid assets? Things can get emotionally tangled [and] the issue could become a financial drain if it goes to litigation."

Problems can crop up even without "blended family" issues, since it's not unusual for a son or daughter to be active in the business while another isn't. "Does the family have the liquidity to transfer an interest in the enterprise to business-active family members while compensating other members with cash or other assets?" he asked. "Many families have most of their wealth tied up in the business itself, so they may not be able to tap outside resources."

One solution could involve dividends and other payments to nonactive family. "It's always best to involve everyone and to do this kind of planning early while the senior members are still alive," Brew added. "This way you can manage the process and help the next generation know what to expect so they can plan accordingly while minimizing any surprises."

Brew

Dula

Tax issues should also be considered. "Depending on specific circumstances, a GRAT — Grantor Retained Annuity Trust — may allow a business owner to transfer the future appreciation of the enterprise to the next generation without tapping into the donor's estate or gift tax exemption," according to Brew.

Under a GRAT, a donor typically has an independent valuation done of the shares of a business or other assets and transfers the property to a trust. In return the donor gets annuity payments from the trust for a period of years. At the end of the annuity, any property remaining in the trust is generally turned over to one or more designated beneficiaries.

GRATs and other trusts can deliver impressive results. "A client who owned a construction company set up multiple GRATs," Brew noted. "The individual was able to transfer a very substantial ownership stake in the company, which was worth about $100 million, down a generation with minimal tax effect."

Multigenerational tax planning involves a lot more than "developing projections and working out ways to minimize taxes," according to Kim Dula, a partner at the accounting, tax and business consulting firm Friedman LLP. "We also act as a family psychologist, gaining an understanding of everyone's goals and making sure they understand the parent's goals while looking at realistic outcomes."

One of her clients, a New Jersey family-owned manufacturing company, had four grown children, but only one showed an interest and aptitude in eventually taking it over.

"Fortunately, the dad started planning early, years before he planned to begin stepping back," noted Dula. "This not only gave us sufficient time to investigate a variety of options, but it also offered the opportunity to modify his plans if circumstances changed."

Dula and her associates "looked at all of the assets of the client to determine how to minimize taxes while achieving an equitable distribution among the family members. We transitioned one part of the business to the daughter who would be active in running it, and used life insurance trusts and the client's real estate investments to ensure equality with the siblings. Of course there were some discussions during the process, but the big win is that the entire family continues to get along, and the father was able to continue to stay involved on a limited basis as a consultant."

By starting early, "you can put structures like a Family Limited Partnership in place," she said, referring to a tax planning tool that can help protect assets from creditors while minimizing estate taxes. "Early planning can also help you to build in flexibility for changes in the tax code."

One big change has Dula somewhat concerned. The federal Tax Cuts and Jobs Act, which generally became effective this year, basically doubled the individual estate tax exemption to more than $11 million, "but I'm worried that some people may be less motivated to engage in succession planning," she said. "Comprehensive planning is much more than taxes — it's also about setting up an income stream, maximizing a business' value in anticipation of an eventual potential sale and protecting the heirs' assets from creditors or possible marital strife."

Dula said she is "working hard" to communicate this to clients. "People need to be aware that even though the federal estate tax has a high exemption — and at the state level, New Jersey has eliminated it, at least for now — states like New Jersey and Pennsylvania still have an inheritance tax. When it comes to taxes, nothing is permanent. The current high federal exemption levels are scheduled to sunset at the end of 2025, for example, so it's always important to continue to plan and to stay aware of what's going on."