

Trusting Your Children With the Family Business

Your family business is more than a mere investment asset. It is your life's work, a legacy to pass on to your spouse and children. Family businesses often pass on tradition, pride and responsibility to employees and the local community, in addition to passing on wealth.

When passing a family business to the next generation, you will have to ask yourself questions such as:

- Who will manage the business?
- How will profits be divided between family members who work in the business and those who do not? and
- How should conflicts among shareholders be handled?

Placing your business into a trust may provide satisfactory answers to these and other difficult questions.

Placing the Family Business in Trust

Let's assume you have one child in the business and two other children without any desire to work there. If the business is worth less than one-third of your total estate after federal estate taxes, you may:

- Leave the business to the child who works there,
- Equalize amounts to the other two, and
- Divide the balance of your estate three ways.

Assuming the child in the business does not mind having all of his or her eggs in one basket, this solution may be done without a trust.

Most of us, however, are not that lucky. Closely held businesses are frequently a large part of the estate, especially after federal estate taxes. If your business will likely be worth more than your working child's share,

consider a carefully structured trust for passing on the business.

The Trustee Advantage

To the degree you can anticipate problems, you can provide the trustee with specific instructions as well as certain broad powers. The trustee must have — among other powers — the power to retain the closely held business in its current or successor form, regardless of what percentage of the trust that may be. Additionally, a trustee ordinarily has a duty to diversify investments to minimize risk. Your instructions are even allowed to compel the trustee to retain the business if the child in the business fails to consent to certain objective financial performance guidelines.

As effective as the power you grant a trustee may be in some areas, conflicts among your children can extend beyond the range of that power. The children outside the business may want to sell the business or have dividends paid, while the child in the business wants to keep it at all costs because it pays his or her salary.

Choosing a Trustee

Your choice of a trustee is important because the trustee controls your share of the business. Choosing a child, either one in the business or one outside it, creates an inherent conflict of interest — that which helps some children may hurt the child-trustee or vice versa. For example, the child in the business may want to retain a major part of the year's earnings for expansion or for a reserve, while the children outside the business may want dividends or distributions.

The child in the business, however, may be the only one who knows enough about the business to be a shareholder. If you believe this child can be fair to his or her siblings, choosing a child in the business as trustee may be the best answer.

A professional trustee may facilitate conflict resolution among children, but realize that as professionals they tend to like risk reduction and could push for eventual sale of the business. If you want the business retained and have chosen a professional trustee, provide specific instructions about the circumstances under which the business can be sold.

Allocating Profits and Selecting A Business Structure

Should you leave it up to your children to divide the profits or should the issue be addressed in your estate plan? The child in the business is entitled to a salary and some additional reward for making the business grow. The children outside the business, however, are bearing a significant amount of risk and should be rewarded.

For example, imagine that your closely held business is a farm. The reward for return on capital (cash rents) is measurable and clearly belongs to shareholders. The balance of profits belong to return on labor and should go to the child in the business. Returns on bearing risk belong to all the children in common.

In addition, the method of payment to various parties is important. Payment methods depend on the business type involved:

C corporations. Dividends from a C corporation are generally inefficient because amounts are double taxed, once at the corporate level and once at the shareholder level. For this reason, consider another form of organization.

Partnerships and limited liability companies (LLCs). Partnerships have the advantage of being taxed only once, at the ownership level. One disadvantage of a partnership is that general partners have unlimited liability, but limited partnership or LLC arrangements can minimize this problem.

If your family business is currently incorporated and you want it to be a partnership after your death, you will have to instruct your executor to liquidate the corporation before distribution of the estate. If the business has other shareholders, they may oppose liquidation because of the significant tax liability it would create.

S corporations. An S corporation is taxed like a partnership. Shareholders must be either individuals who are U.S. citizens or residents or trusts that meet certain conditions. An electing small business trust (ESBT) can be a good option because it can have more than one beneficiary, unlike other trusts that qualify to be S corporation shareholders.

Minor Children

What if your children are minors or have not yet settled into careers, and it's unclear which child, if any, will go into the business? A trust is a good solution to this problem. You will need a trust with more than one beneficiary so that the trustee can exercise discretion or follow trust directives in allocating and distributing stock among the children who are active and inactive in the business.

Anticipate Problems, Create Solutions

A trust cannot cure all the difficulties of passing a closely held business to the next generation, but it can help. We can also help you anticipate problems and create an estate plan to solve them.