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Wealth Management

Keeping the Money in the Family

Effective succession planning for family-owned businesses

By Priya Prakash Royal

Family-owned businesses are the backbone of the economy in the United States. In February 2006, *Business Week* reported that family-owned businesses account for more than 50 percent of the United States gross domestic product. Stacy Perman, "Taking the Pulse of Family Business," *Business Week*, Special Report — Family Owned Business, February 13, 2006, www.businessweek.com/smallbiz/content/feb2006/sb20060210_476491.htm. The Small Business Association Office of Advocacy reported that small businesses represent 99.7 percent of all employers in the United States, based on 2005 statistics. Small businesses are characterized as those with 500 or fewer employees. This means that a large percentage of the clients of attorneys with a business practice will be small businesses — and many will be family-owned.

Prakash Royal is an associate with Carlin & Ward of Florham Park. She has a Masters of Law in Taxation.

Attorneys in general business practice should be aware of one critical aspect of a client's business when the business is family-owned: estate planning. Division of the interest, transferring management and succession are just some of the issues that arise at the end of one generation of ownership and the beginning of the next. Proper planning for the future of the business provides the bridge that ensures that the family-owned business will retain its structure and, more importantly, its culture as it passes from one generation to the next.

Few small businesses, including closely held family businesses, have in-house counsel to handle complex tax and business issues. Considerations, such as the advantages and process of effective use of gift tax provisions and recently increased expensing limits under IRC Section 179, are central to giving proper legal advice to small business clients. Succession issues are also a crucial factor in family-business planning.

Several tax deductions were passed into law in the 1990s when the legislature realized that the survival of small business was central to economic growth. As a result, there are deductions on the self-employment tax, increased minimum 401(k) contributions, and an AMT credit. Paying salaries and providing benefits (under a SIMPLE rather than a traditional 401(k) plan) may lower the taxable profits incurred by a business.

Structuring the business in a tax-favorable way is an important consideration. For example, S Corporations are only subject to one level of income tax on the federal level; thus, small business owners (as long as they meet the S Corporation requirements under IRC § 1361) can benefit from paying less in federal taxes.

Several code provisions result in a different treatment of family-owned businesses, exemplified by family attribution rules, IRC § 1563 and IRC § 263. Stock ownership attribution rules apply when the owners and their lineal descendents are minors, which create additional control issues. IRC § 267 also prevents the current use of a loss on a sale between related parties. Failure to address the attribution rules and their impact can have devastating consequences by limiting or prohibiting certain deductions, such as the deduction for losses.

In 2006, the deduction amount on qualified Section 179 property was increased. Under this provision, instead of depreciating the cost of a property for business over several years, a sole proprietor, partnership or corporation can fully expense tangible property in the year it is purchased, provided certain requirements are met. The capital expenditures limit was expanded in 2006. Even off-the-shelf computer software, which had to be written off over three years, was placed under the umbrella of Section 179. The Section 179 deduction does not apply unless the taxpayer elects to do so. The deduction is subject to annual limitation and is limited to taxable income. However, the deduction can lower the adjusted gross income and earned income, and it is available for any property placed in service during the taxable year, even on the last day.

Retiring from a closely held small business corporation, including family-owned business, can have federal income tax benefits. The retiree's receipt of tax-free Social Security benefits, along with conversion of earned income into unearned income including capital gains arrangements, can lead to multiple tax savings. Gorman Ledbetter, "Tax savings at retirement for the owner of a small business corporation" at http://www.allbusiness.com/print/102144-1-22eeq.html.

To take full advantage of the income tax provisions, proper characterization of the income is essential. Unearned income, including rental income, dividends, etc., is not subject to self-employment taxes and is, therefore, preferable to earned income. IRC § 1402. Capital gain deductions are also a possibility if the retiree sells property to the corporation, assuming certain ownership limitation requirements are met. Rev. Rule 59-22, CB 1959-1, 225. Tax practitioners should carefully consider, among others, IRC §§ 203, 1402, 1239 and the related Revenue Rulings before giving planning advice to an entrepreneur seeking to retire.

Enotes.com reported in June that at any given time, 40 percent of American firms are facing succession issues but few make succession plans. Less than one-third of family businesses survive the transition from one generation to the next because most family business succession planning is either performed too late or never considered. Practitioners should advise clients to consider succession planning at the time of the inception of the family business. http://business.enotes.com/small-business-encyclopedia/family-owned-businesses/print.

The more complicated topic is estate planning. Improper estate planning may lead heirs to liquidate the business to pay the estate taxes, when the goal is to prevent this by lowering estate tax liabilities.

A crucial component of family succession planning is minimizing the tax burden at the time of the owner's death so that the maximum resources stay in the family and the business. Options such as "freezing" the value of the business at a particular time, creating preferred stock (which does not appreciate in value) and transferring the common stock to the heirs may reduce estate taxes as most of the shares in the firm would be preferred stock. However, the gift tax consequences to the heirs must be balanced against the estate tax reduction benefit. This option is limited under the code and therefore any plan incorporating such Chapter 14 special valuation rules should be structured carefully.

The family business "package" should include: a will, which discusses distribution of the property at the death of the owner; management of the business in case of the owner's incapacity (living will); establishment of a marital deduction trust if it will result in lower estate taxes cumulatively; installment payment of taxes; and use of the annual exclusion gift provisions under IRC § 1015. A review of Chapter 12 of Subtitle B (Gift Tax), the additional basis adjustment rules under IRC §§ 1014, 1016, 1022 (for decedents dying after 2009), should be factored into the evaluation where necessary.

The will should address the following preliminary issues: entitlement to voting shares; which members of the family can be employed in the business; the long-term strategic goals of the business; the dividend policy; the lines of communication between the family and the board; the extent of the family's authority or control over the business and the extent of outside (non-family) management.

When the business is passed along while the owner is still alive, without proper planning the gift tax provisions may result in adverse tax consequences. In addition to the income tax to the successors, the owner would have to pay gift taxes on the amount that is in excess of the sum of the annual exclusion amount and the lifetime exception (assuming no prior gifts were made). The owner's lifetime unified credit would be reduced by the amount of gift tax not paid. A tax-planning device may be used to incorporate the business, so that the interest can be transferred by giving shares of stock instead of assets. However, incorporation may result in other costs, tiresome filing and due diligence obligations that may outweigh the potential tax savings in the estate.

The proposed repeal of the estate tax (completely phased out by 2010) offers an incentive to maintain greater control of assets instead of creating more entities and transferring fractional interests to lower the estate tax liability. The repeal would facilitate administration and would eliminate the need for deferred payments of death taxes, the creation of trusts for estate tax purposes and the use of the special use valuation provisions. Unless it is permanently repealed, the tax will be reinstated in 2011. A bill introduced last month, HR 2380, was introduced to permanently repeal the estate tax.

The qualified family-owned business exclusion was signed into law in August 1997. Since then, the county has seen a boom in small business enterprises. This exclusion reduces the adverse impact of estate taxes as the business is passed from one generation to the next. Provided certain requirements are met, this provision allows a deduction up to a certain amount which cannot exceed $1.3 million.

The application of the exclusion is limited because several requirements must be met for the estate to qualify. The principal place of business must be in the United States, and there are specifications on the ownership interests required by the family and on the required portion of ownership by the decedent's family. The value of the estate's qualified family-owned business interests must be greater than 50 percent and cannot have equity or debt that is readily tradable on an established securities market or secondary market. IRC §2057(e)(2)(A).

Tax practitioners should be mindful that effective succession planning and a thorough knowledge of the unique rules applicable to family-owned businesses are essential to proper business planning. ■