Critical planning for the closely held business

BY JESSICA GALLIGAN GOLDSMITH

Owners of closely held family businesses face certain unique challenges. Chief among them is who will run the business in the next generation. Sometimes the answer is obvious, but often the answer is unclear. While business succession planning can be a difficult task, it is critical for every family business. Both tax and family considerations come in to play when transferring a family business to the next generation, and careful attention must be paid to all aspects of an owner's estate plan.

Family businesses are complex entities, and different individuals and generations can have competing interests. Often, some of the owner's children work in the business, but others do not. In these situations, relationships between parents and children in and out of the business, and relationships among siblings, must be considered. Sometimes, none of the children has any interest in the family business. This situation presents its own planning concerns.

In order for a family business to thrive into the next generation, there must be a plan in place for continuing centralized management. It is rarely possible for multiple siblings and cousins to run a business as effectively as one or two original owners. Therefore, one of the most important things a family business should have is a written plan for management succession. Depending on the type of business entity, this plan is usually embodied in an L.L.C. operating agreement or a shareholders' agreement.

A well-drafted operating agreement or shareholders' agreement should also restrict transfers to non-family members. Transfer provisions should allow current owners to make gifts of business interests to family members and family trusts, but should not allow any subsequent disposition of business interests to non-family members without permission from current management. Gifts by owners of family business interests to family members can be highly leveraged and therefore very effective from an estate and gift tax standpoint. Appropriate transfer restrictions help keep the business within the family, and also often provide discounts against estate taxes for the owner's estate and the child's estate.

When an owner's child marries, a prenuptial agreement is highly recommended. It can ensure that the business remains in the family and is not transferred to a child's former spouse on divorce. Under New York law, when a child dies without a prenuptial agreement, the child's spouse is generally entitled to one-third of the child's estate (or one-half, if the child has no children), regardless of the terms of the child's will. A prenuptial agreement can allow the child to provide business income for a surviving spouse while ensuring that the business itself stays within the owner's family.

Family business owners are often unwilling to engage in any estate planning because they are not ready to cede control of the business. However, different estate planning vehicles allow owners to move assets down one or more generations while continuing to maintain control of the business for a period of time.

For example, sometimes life insurance held in an insurance trust or owned by the children can offer much-needed liquidity. In 2012 and beyond, gifts and/or sales of business interests can be made to children and grandchildren, or to trusts for their benefit, with a minimum of gift tax and generation-skipping tax impact. Limited liability companies, often combined with family trusts, can help owners stay in control of a business until they are ready to retire, while moving future appreciation now to future generations.

In addition, a special provision of the Internal Revenue Code allows certain family business owners to defer the payment of estate taxes over a 10- to15-year period. The combined federal and New York state estate tax rate in the top bracket in 2012 is 42%. In 2013, the combined rate is scheduled to rise to approximately 62%. Section 6166 of the federal tax code and its New York equivalent help certain family business owners avoid being subjected to massive estate taxes that can force the sale of the family business, or require the business to incur significant debt, following the owner's death. Because only certain kinds of business interests qualify for section 6166 deferral, it is extremely important to structure one's family business and estate plan in order to permit the application of section 6166 in the owner's estate.

For these reasons, family business owners should meet with their advisors sooner rather than later to be sure that their estate and business succession plans are both appropriate and effective from a tax and family standpoint.

Jessica Galligan Goldsmith is a partner and chair of the trusts and estates department of Kurzman Eisenberg Corbin & Lever L.L.P. in White Plains. She can be reached at (914) 286-6370 or jgoldsmith@kelaw.com.