Fair vs. Equal:
Legacy Planning for the Family Business

Ask any parent how they want to divide what's left after death, and they'll probably say, "I want my children to be treated equally." In many instances, that distribution scheme works well. In other instances, special circumstances require special treatment such as when a child:

- has physical or mental disabilities
- has addictions or other self-destructive behaviors
- is an active participant in a family business

The first two situations obviously require special treatment when considering legacy planning. In the first instance, most individuals are aware that states make funding available under Medicaid for individuals with special needs. Any legacy available directly to a person eligible for state benefits may jeopardize the availability of all state benefits. If benefits have been paid, the beneficiary's legacy could be taken to repay the state.

A child with destructive behaviors or addictions most likely is in need of oversight when it comes to having readily-available cash or other assets. In many instances, parents leave assets in trust, and language in the trust document dictates the circumstances under which that beneficiary receives a distribution. Often the trustee will make payments for care, rent, or mortgage obligations directly to the institution to avoid cash going through the beneficiary's hands. It is not uncommon these days to see trust language directly address what a beneficiary must do in order to qualify to receive payments in the event of illness or addiction.

Where an only child is an active participant in a family business, there may be no issue at all about distribution or equalization, primarily because there is no one with whom to share an inheritance. Siblings make all the difference, particularly when there are siblings who are not involved in the family business.

Planning for the succession of a family business can go beyond a discussion of equal vs. fair. It's important to take into account the desires of the current owners. Should the business be transitioned now, or later? In other words, is the current owner willing to cede the reins of the business and retire, or is it not yet time to ride into that proverbial sunset?

Should the business be transferred later, perhaps after a few more years of retirement savings accrue, or after the owners are satisfied the heir-apparent is truly ready to take over the responsibility for the business?

WHAT IS FAIR?

Let's examine the word "fair" from two perspectives: the parent's and the child who works in the business.

Parents believe they are being fair when they have their estates split equally among children, because they may believe it is the most logical thing to do. Further, they may feel that to do otherwise would create animosity amongst their children.

A child who works in the family business, who wants to continue the business and who is capable of doing so may feel that a legacy plan leaving part of the business to siblings who aren't also co-workers is extraordinarily unfair. There are at least two reasons they might feel that way:

1. **Use of profits**. Should the business produce profits, there may be a conflict in what to do with the profits. The child in the business may very well see a need to reinvest those profits in equipment, systems, inventory or employees. The child who is only an investor by virtue of her inheritance may prefer a distribution of cash.
2. **Distribution of profits**. If the business is a C corporation, tax is paid at the business level on business profits. Shareholders pay tax only if a dividend is declared or if they sell their shares. Flow-through entities, however, pass through profits and losses to all shareholders, members or partners. Many closely-held businesses are structured as flow-through entities, causing a pro-rata sharing of the tax ramifications. Here's where the conflict can occur: a child working as an employee in a business she owns earns income, some of which can be used to pay tax on the profits allocated to her as a shareholder. The child who is merely an investor, however, may not have or may not wish to use "other" money to pay tax on profits from the family business. That may lead to heated discussions about distributions. If the employee-child is not the majority owner, her siblings could vote against her and force a distribution, whether it's in the business's best interest or not (see # 1). If the employee-child is the majority owner who refuses to make a distribution, she may find herself without an invitation to Thanksgiving Dinner next year.

When parents are made aware of the conflicts that can develop amongst their children as a result of a desire to treat the children equally, many realize those consequences are not a legacy they'd want to leave. What are some suggestions for owners of family businesses in this position?

PLANNING THE FAMILY LEGACY

Planning begins with an inventory of assets and a discussion about the owners' goals and objectives for both the business and their estates. There is much to be learned about the working relationship of the family members and the confidence there may or may not be in the next generation's ability to continue the business.

The following case study will help us examine some of these issues. Let's meet the Ambersole family and make some assumptions about them and their situation:

- Mr. and Mrs. Ambersole have three children. One child, April, is in the business and is ready, willing and able to continue the business. She has two siblings, Bob and Cathy, who have found other vocations.
- The Ambersoles own a cattle ranch (RanchCo). For the past 40 years, Mr. Ambersole (A) has been the driving force behind the business. Mrs. A has worked as the bookkeeper and money manager for RanchCo, and now that her children are grown, she volunteers for local charities.
- RanchCo is an S corporation. A qualified plan for employees was established several years ago.
- RanchCo is comprised of three separate businesses. One manages the operation, another owns the cattle and other animals, and a third owns the real estate and equipment.
- Overall, the business as an entirety has been extremely profitable over the past 40 years.
- RanchCo is the bulk of the Ambersoles' estates.
- Mr. & Mrs. A would like to have all three children share in their legacy equally, but they understand the conflicts discussed above.

There are at least three ways to approach this, all involving a buyout agreement.

1. **Buyout at Second Death: Fair and LATER**
   a. April and her parents enter into a buy-sell agreement. The agreement stipulates that April will buy any remaining business interests when her last parent passes away.
   b. April purchases survivorship insurance on her parents to facilitate the buyout.
   c. In conjunction with the buyout planning, Mr. and Mrs. A amend their wills to provide that April will receive one-third of the businesses at the death of Mr. A if he predeceases Mrs. A. April, as a minority owner, has an incentive to keep the businesses productive.
   d. Assuming Mr. A dies first, Mrs. A has continued income and still owns two-thirds of the business.
   e. Siblings understand that April is essential to maintain business productivity in order to provide for their mother, and thus are willing to accept that April became an owner through an inheritance earlier than theirs.
   f. When Mrs. A passes away, April uses the life insurance proceeds to purchase the remaining business interests, making cash available in the estate which can be used as a mechanism to provide liquidity to the estate for any estate taxes as well as for estate equalization. Since April essentially received her inheritance at the death of their first parent, the remaining estate assets pass to her siblings.

2. **Buyout at First Death: Fair and NOW**
   a. Assume the facts above, except that Mr. A wishes to make April an owner as part of their lifetime planning.

b. Mr. and Mrs. A first reorganize their S corporations into voting and non-voting stock).

c. Mr. and Mrs. A retain the voting stock, thus continue to control the entire business operation.

d. Mr. and Mrs. A then use some or all of their lifetime gift tax exemption to pass as much of the non-voting stock to April as possible. Using a promissory note, April will purchase any non-voting stock not passing during life at the death of the first parent to die.

e. Mr. and Mrs. A create an irrevocable grantor trust for the benefit of Bob and Cathy, and the trustee of the trust purchases survivorship life insurance on Mr. and Mrs. A.

f. They adjust their wills to pass ownership of the voting stock and any remaining non-voting stock of the businesses to April at each of their deaths.

g. At the second death, the insurance is used to create liquidity for any remaining estate assets and to create a legacy for April's siblings.

3. **Buyout of Siblings: Fair and Equal**

a. Assume facts as above, but instead, Mr. and Mrs. A handle the business disposition entirely with their wills.

b. The wills specify that one-third of the businesses each owns will be distributed outright to April at each parent's death. The wills also leave the decedent's remaining share of the business to the spouse who survives, and if no spouse survives, then the interests pass to a testamentary trust for the benefit of Bob and Cathy. The wills contain language stipulating that the trustee must sell the businesses to April upon the death of the last to die of her parents.

c. April purchases survivorship life insurance on her parents for the amount of two-thirds of the business.

d. When the last parent passes away, April receives the balance of her share of the business inheritance, and uses the life insurance proceeds to purchase the balance of the business from the trust for her siblings.

Any of these three methods allow Mr. and Mrs. A to treat their children equally, but also with an element of fairness. April, who has proven her ability with the business, is allowed to continue it without the need to consult her siblings about profit use or sharing. Bob and Cathy see that the business will continue to support the parents during life, and they'll be treated fairly—with substantial cash—after their parents have passed away.

FAMILY LEGACY PLANNING WHEN SIGNIFICANT NON-BUSINESS ASSETS EXIST

Our example above involved a family whose business comprised the bulk of the parents' estates. There are different considerations if the business is small in comparison to the other wealth the parents may have.

Significant assets independent of the business can actually make estate equalization easier. First, it may be likely that income from the business may not be crucial to the support of the surviving spouse's lifestyle, making a first-death transfer of the business to one or more children in the business an easier transaction. The business can be left to the appropriate parties at the first death, and the balance of the estate can be left to the surviving spouse and other children. An important point to plan for, however, is the likelihood that a direct transfer at the first death may trigger estate tax. The parties inheriting the business at that time could purchase life insurance on the owner, and lend the cash to the estate to pay the estate tax. Alternatively, the parent can set up a grantor trust during life to own the insurance.

Second, significant estate assets can simplify the division of the estate at the second death. If we assume the parents wish the business to pass at the second death, then the wills would provide that the business interests are bequeathed to the children in the business and other assets transfer to those children not in the business.

Not every situation, however, will have non-business assets perfectly-proportioned to completely provide for children not involved in the business. In that case, life insurance in trust can be used to even-out the legacies for the next generation. Let's go back to the family situation above involving Mr. and Mrs. Ambersole. If RanchCo comprises one-half of the estate, then the trust-owned life insurance can be used to supplement the non-business assets for Bob and Cathy. If RanchCo comprises only one-quarter of the estate, then trust-owned life insurance can be used to make April's inheritance better match that of her two siblings.

VARIATIONS ON THE THEME

Although the alternatives above address the issue of estate equalization, there are probably as many ways of handling this as there are situations. Here are some examples:

- **Private Annuity:** April buys out her parents during their lifetime with a private annuity. While this can be a particularly logical method, especially if her parents are not healthy enough to qualify for a life insurance policy, a private annuity can cost April far more if her parents live longer than the actuarially-determined annuity.
- **Self-Canceling Installment Note:** To counter the longevity risk of a private annuity, some would suggest April use a self-canceling installment note (SCIN). Similar to the private annuity, a SCIN allows April to buy the business over time, and any balance on the note would be canceled at the parent's death. A SCIN can get a bit complicated as well if both parents are owners. This typically is explored if one parent owns the business. It can also be useful after a first parent dies, who has bequeathed the business to a surviving spouse. The business interest can be purchased from that surviving spouse using a SCIN.
- **Life Insurance:** Parents leave the business outright to the child or children in the business and purchase life insurance in trust to fund the value of the amount they believe will be a "fair" inheritance for children not involved in the business.

CONCLUSION

Perhaps the best summary is to think about what happens to the family and family business if the subject of estate equalization is not examined during the owners' lifetimes. If the situation is ignored, a child in the business will find herself working for their siblings who probably would prefer to simply have cash as an inheritance. When the question of how profits are to be used arises, a clear conflict exists between the child working in the business and the siblings who do not. Remember, all the children now own the business. A distribution of profits may undermine the future growth and success of the business. A child in the business who is out-voted by siblings may be unable to operate the business as she believes it should be. Worse, she may find herself out of a job if the siblings decide the business should be sold to outsiders or an outsider should be hired to run the business.

One more difficulty that could arise after a first death: a second marriage. A child in the business could lose the business entirely if a step-parent over-steps his bounds with undue influence, especially if the second spouse feels the business should be sold for income. For that matter, a surviving spouse who doesn't remarry could force that sale if the business was left to a QTIP marital trust, regardless of any consequence it would have on the child.

Parents who are concerned about family harmony after they're gone are wise to address the issues of estate equalization as a key element of their estate and business planning. Most of the problems that would create disharmony in their children can be handled with careful thought and with wills, trusts and business agreements that clearly dictate the legacy plan. The last step is to have a family meeting to discuss the plans, answer questions from all sides, and to reinforce the reasons and strategy behind the planning.