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Prodigal Son Redux?

Balancing the family business and bequests to your children

By Lou Vlahos

"There was a man who had two sons; and the younger of them said to his father, "Father, give me the share of property that belongs to me," and he divided his land between them. Not many days later, the younger son gathered all he had…and squandered his property in loose living." With apologies to St. Luke, the spendthrift son returned, tail between his legs, to his father's home, and the old man prepared a feast for him. But the older brother "was angry…and answered his father, "Lo, these many years I have served you, and I never disobeyed your command; yet you never gave me" " a dinner (to paraphrase the late Red Buttons).

I have never accepted the parable of the prodigal son. I have always sided with the older brother, and I am certain that I am not alone.

However, query how a parent with a business will treat his children when one is actively engaged in its operation (the "participating child") while the other is not. The question presented is especially difficult where the business constitutes the greatest part of the value of what will be the parent's estate. The parent's natural inclination may be to treat the children equally, sometimes "fairly" (not necessarily the same thing). In any event, the parent typically wants to provide each of them a measure of security and the opportunity to succeed - but how?

Scenario

One option would be to give each child an equal share in every asset, including the business. If it is likely that the children will not be able to work together – and who better than the parent can foresee this not uncommon result – and the business is comprised of different lines of business, or operates in different locations, it may be advisable to divide the business into two separate (though not necessarily equal) parts (via a split-up or split-off, preferably on an income tax-free basis). This would give each child an opportunity to make his or her own way and to benefit from his or her own efforts. But is this division the best option for the business and, consequently, for the family's long-term financial well-being?

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Scenario 2

In a case where the parent has other, non-business assets of significant value, he or she may pass the business along to the participating child, with the balance of the estate passing to the non-participating child. Even then, however, friction may develop between the children. For instance, in a situation in which only one child is involved in the business and the parent owns real estate, perhaps through a pass-through entity (like an LLC), that generates rental income, what if the business operates on the real property? In that case, other factors must be considered. Does the business pay fair market rental to the real estate entity? Is there a written lease? How are expenses and capital expenditures allocated between the tenant business and the property owner? Who should control the real property entity; the child who is not in the business? Will this effectively give the non-participating child undue influence over the business operated by the other child?

Scenario 3

Where the parent has few options in the way of other, non-business assets with which he or she may "equalize" the treatment of the children, the parent may want to look into obtaining life insurance on the parent's life "for the benefit" of the non-participating child. This policy may be acquired in a life insurance trust, so as to keep it out of the parent's gross estate and, thus, undiminished by estate taxes. Upon the parent's death, the policy proceeds may be distributed to (or held for the benefit of) the non-participating child or they may be used for another purpose, as described below.

Planning for Scenario 1

Where it may be too expensive to acquire sufficient life insurance coverage so as to "equalize" the children, and there are no other available assets, the parent will have to plan for the transfer of equity interests in the business to each of the children, both participating and non-participating.

In order to prepare for this eventuality, the parent should consider the adoption of a shareholders agreement and the recapitalization of the business's equity into voting and non-voting interests. (Note that such a capital structure is available in both S corporations and limited liability companies. In general, the recapitalization may be effected on an income and gift tax-free basis.) The terms of the shareholders' agreement will depend, in part, upon whether the non-participating child will continue as an equity owner or not. If not, then the agreement may give the participating child the right to purchase the other child's equity interest at fair market value (as determined by an appraisal, and being mindful of the estate tax valuation in the parent's estate, perhaps with an adjustment if the business is sold at a greater price within two years). The terms of such a purchase should be spelled out as well; for example, $X at closing, a Y-year promissory note (accruing Z percent interest) for the balance. If there is some life insurance available on the parent's life, the proceeds there from may help to fund the purchase.

If the non-participating child will remain a shareholder – for example, where an immediate buyout may be too expensive – then the parent should consider giving the voting equity to the participating child and the non-voting to the non-participating child. In this way, the non-participating child will not be able to interfere with the operation of the business (though he or she will still have certain rights and remedies as a matter of state law; the participating child does not have carte blanche). In addition, the shareholders' agreement may provide for the buyout of each sibling's equity in the business upon either sibling's death (which may necessitate the acquisition of life insurance on their lives). The shareholders' agreement may also provide the participating child with drag-along rights so that, in the event of a proposed sale of the equity, that child can force the non-participating child to also sell his or her equity. At the same time, the agreement should provide that the non-participating child should not be able to freely transfer or pledge his or her equity. In some cases, in order to further remove the non-participating child from the business, and to further limit his or her ability to intervene in, or to interfere with, the business, that child's shares may be transferred into a trust for his or her benefit. A trust may

also be advisable where the non-participating child has creditor or marital issues, or when the parent seeks to provide for that child's own children.

On the other hand, the parent must recognize the fact that the child in the business will be able to draw down a salary, while the non-participating child may not even be employed by the business. The participating child will also be in a position to declare, or not to declare, dividends. There may be valid business reasons for reinvesting net earnings (as opposed to paying a dividend) - for example, to pay down debt, to update equipment, or to expand – but that may not assuage the non-participating child.

The shareholders' agreement should address distributions; for example, will there be mandatory distribution for taxes (in the case of a pass-through entity, like an S corporation, partnership or LLC), or will they remain discretionary with the participating child? This can be a tricky issue because that child also controls compensation decisions. Although it is proper that the participating child be reasonably compensated for his or her efforts, including bonuses after a particularly good year, the fact remains that a non-participating child will likely become very resentful; after all, he or she owns an interest in a valuable business from which no present economic benefit is being derived. Indeed, under such circumstances, the non-participating child's only prospect of enjoying the wealth passed to him or her from the parent would be on the ultimate sale of the business, the likelihood of which may be remote.

Speaking of the non-participating child, it may make sense to include a tag-along right in the shareholders' agreement, so as to enable that child to participate in any sale of equity being contemplated by the participating child. It may also make some sense to give that child the right to put a limited number of equity interests to the business entity (a redemption or partial liquidation of that child's equity) or to the participating child, at designated times, and under certain conditions, in order to generate some liquidity, but without impairing the business.

Clearly there is much for the parent to consider. Many of these issues will be difficult, and possibly expensive, to resolve. The forgoing has considered only some of the most commonly encountered issues. (Others, like the payment and apportionment of the parent's estate tax liability among the children, merit a separate article.)

At the end of the day, and after considering the options, the parent may conclude that the most reasonable thing to do is to sell the business, rather than leave it to one or more of the children. A sale for cash will certainly allow the parent to treat the children equally, inasmuch as each will share equally in the proceeds of the sale. Even that, however, may create resentment where the participating child's livelihood (and perhaps that of some of his or her children) is thereby jeopardized.

There is no easy answer, but the planning exercise described above is a worthwhile one. Where the obvious choice is to leave one child in charge of the business, the parent may want to start transferring some managerial authority over, as well as some equity in, the business to that child as early as possible, so as to set the stage for the ultimate operation and disposition of the business. That is a subject for another article.

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