



Exit Planning Information & Education For America's Business Owners

The Exit Planning Review™ is an opt-in, bi-monthly newsletter published by Business Enterprise Institute, Inc.

This issue is provided to you by your JD Ford & Company professional, [Joseph Durnford](#).

For an overview of Exit Planning [click here](#)

Our Executive Briefings keep our friends and clients on top of innovative Exit Planning trends and techniques. To view a schedule of upcoming Briefings, please [click here](#).

PROVIDED BY



Issue 80

FAMILY BUSINESS TRANSFERS Part Four: The Recipe for Success:

Ingredient 3 Being Fair to All Children

In the prior issues of this newsletter, we described a specific recipe for creating a successful intergenerational transfer. The first ingredient in that recipe is to undertake the Seven Step Exit Planning Process (modified for family business owners) and the second is to allow only one child succeed in business ownership. (For a copy of either issue, please contact [Joseph Durnford](#).) The third is to design a transition that is fair to all children.

Third Ingredient: A business transition that is fair to all children

Most parents have a natural inclination to distribute every asset equally to all children. The thought of giving one asset, and very likely the most valuable asset, to one child is considered unequal and, therefore, unfair to the other children.

Yet, upon closer examination, leaving the business entirely to the business-active child (BAC) *and* making an equitable distribution of the balance of family assets to the inactive children (and perhaps to the BAC as well) is the fairest plan of all.

"Fairness" in this context is usually a judgment parents make about what *they* think is fair to the children. What it overlooks is what the *children* deem to be fair to each of them. This perspective is all too often missing in family transition planning. To determine what is fair, assume the point of view of the business-active child and then that of the inactive child.

Let's look at why the *business-active child* might well resent having a co-owner sibling who is inactive in the business. Perhaps one of these reasons applies:

- It is the efforts of the business-active child to increase the value of the business that should be rewarded. You probably offered all of your children an *equal opportunity* to participate in the business and become owners. Yet, only one child seized that opportunity. Why force your most ambitious, risk-oriented child - the one who chose to succeed you - to share the rewards with children who chose different career paths?
- You had no co-owners in the business because you wanted to operate the business independently. As an entrepreneurial "chip off the old block," your child doesn't want to share ownership any more than you did.
- The controlling vote is not enough! When there are co-owners, the child running the business has a fiduciary duty of due care and loyalty to all other shareholders. That means that the business-active child's actions, such as giving herself a bonus, or increasing her own salary, or indulging in other business "perks" (as you do), must all be reasonable and comparable to what a non-shareholder performing the same duties for the company might reasonably expect. I doubt you would subject *your* compensation and perks to the same level of scrutiny.

And what about the *inactive child's* perspective? Inactive children are unlikely to want ownership in the business, if other choices are available.

- Inactive children generally prefer to own, or receive, assets that are more liquid and less risk-oriented than ownership in the business. This is usually true even if they have to wait until both parents die to receive their inheritance.
- If the inactive child owns part of the business, have they received anything of real value? Partial business ownership will make the inactive child the proud owner of an illiquid security that generates no immediate income or other benefits. Further, the inactive child has no ability to sell his interest, except to the business-active child. Yet, that's hardly a problem since the active child won't, in all likelihood, have the money to purchase it. And, if he does, the business-active child's idea of fair market value is likely to differ dramatically from that of the inactive child. Congratulations! You've created your own Cain and Abel!
- It would seem from the above point that the inactive child's ownership interest would have little value. The (now friendlier) IRS begs to disagree. While a non-controlling ownership interest can certainly be discounted in value, it will nevertheless rise in value as the overall business value increases (due to the efforts of the business active child). Because it is difficult for the inactive child to get rid of the ownership, he or she has to deal with the tax consequences.

- And one last thing. Keep in mind that the inactive child will not be able to make any decisions regarding the future course of the business.

If only one child should own the business, how do you find the second ingredient - fairness to all children - when transferring the business to the business-active child and other assets to the inactive children? Obstacles to a *fair* transfer of assets include:

- The business value may be significantly greater than the combined value of the remaining family assets.
- If part of the business value is attributable to the business-active child's efforts, is it not fair to consider that part of the business to be that child's interest now? How do you determine the active child's contribution to existing business value?
- And let's not forget the timing issue. It makes good business as well as income and estate tax sense to transfer a significant amount of the business *during your lifetime* to the business-active child. The inactive children, however, will not likely receive their "share" of the family wealth until after you and your spouse die. The reason for this is simple: the non-business assets are usually retained by you to provide income and financial security to you and, after your demise, to your spouse. The resulting timing difference is mitigated by the liquidity difference in the assets the children receive. The business-active child may receive assets now but his assets are highly illiquid and subject to business risk. The inactive children may have to wait but the assets they receive will be highly liquid and relatively risk-free
- In addition to the present difficulty of distributing business and non-business assets equally, there is an added complexity of measuring the *current value* of the business interest given to the business-active child against the *future value* of the bequest given to the inactive child. To understand the present vs. future value conundrum consider the following:
 1. Is the business-active child, in effect, paying for the business now through "sweaty-equity" (lowered compensation, more working hours, and greater risk)? If so, the current gift is not really a gift, but recognition of that child's efforts.
 2. Is the business-active child adding to the business's value through his or her efforts? If so, he should not have to pay for that effort by receiving a reduced share of the ultimate estate.
 3. Has the active child (by continuing in the business after your retirement) become a critical element in your retirement plan by ensuring that the business can pay you any deferred compensation and purchase your stock? If so, the means by which you tie her to the business - the golden handcuffs -

may be the transfer of stock. Again, acquiring stock because it benefits you should not penalize the business-active child when it comes to sharing in the estate.

4. Is the business active child paying for part or all of the business?

How can one possibly find the correct measure of this ingredient?

For most families, the decision ultimately comes down to a discussion of fairness vs. equality. Because the difference in contribution to the business and differences between assets being gifted (business vs. non-business and consequent timing difference) it is imperative to be *equitable* or *fair* in treatment, not necessarily *equal*. Parents must strive to be fair. They must communicate and explain this strategy to *all* of the children. Often it is best to hold a family meeting using advisors to facilitate the discussion.

Finally, be certain to make appropriate adjustments in your will, trusts and buy-sell agreements to apportion assets if your lifetime transfers of the business and other assets are not completed before your demise. As part of those documents, the business active child should have the right to have her share of your estate consist of business interests while the remaining children have the right to have their portion of the estate satisfied with other interests.

*Subsequent issues of **The Exit Planning Review**[™] discuss all aspects of Exit Planning. The provider of this Newsletter (durnford@jdford.com) offer you unbiased information about what you most need to know - *How To Run Your Business So You Can Leave It In Style*[™].*

[^Top](#)

Disclaimer: The information contained in this article is general in nature and is not legal advice. For information regarding your particular situation, contact an attorney or tax advisor. This newsletter is believed to provide accurate and authoritative information related to the subject matter. The accuracy of the information is not guaranteed and is provided with the understanding that none of the providers of this newsletter, including Business Enterprise Institute, Inc., is rendering legal, accounting or tax advice. In specific cases, clients should consult their legal, accounting or tax advisors.

© 2005 Business Enterprise Institute, Inc. All Rights Reserved.
(<http://www.exitplanning.com>)