
Trusts and Estates

Estate Planning Considerations for Closely Held Business Owners

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Owners of closely held businesses and their families can benefit in many ways from a well thought out and implemented estate plan that appropriately addresses the business interests, which often comprise a significant part of a family's net worth. Most such business owners have a number of uniquely challenging objectives to manage in planning for their demise. The issues vary depending on whether a business owner is the sole owner, has co-business owners, or has (or hopes to have) children in the business. Another key facet is whether there is a strong likelihood that the business will still be owned by the business owner at death, or whether there is a desire for an "exit" before death.

Often a business owner's top objective, from an estate planning point of view, is to maximize the value of the business interest for the benefit of his or her family. The best way to do this is generally to have business partners or key employees who will be able to carry the business forward in the event of their demise. Because businesses do not run themselves, it is essential to have a plan in place for who can replace the business owner's role in overseeing the business. That could be one person or a group of people.

When business partners are involved, it is advisable to have a "buy-sell" arrangement in place so that the surviving partner(s) will have the right or obligation to buy out the interest of a deceased partner. When practical, a purchase obligation should be partly or completely funded with life insurance so the surviving partner(s) will have access to the cash they will need to make the purchase. Without such cash, they will generally need to rely on bank or seller financing, which often creates undesirable risk and complexity for a deceased business owner's heirs.

When one or more children are expected to work in the business while others likely will not, a business owner must contend with whether it is appropriate to nevertheless give all children an equal interest in the business, or whether a different approach is appropriate. While no two situations are the same, typically a business owner finds it's best not to have children who don't participate in a business have a stake in it (mostly for the sake of family harmony, but also to avoid potentially meddlesome interference in business operations by outsiders). Ideally, in such cases, the children in the business will buy the business from the parent or siblings. Alternatively, if the business owner has sufficient other assets (including life insurance), the children who don't participate in the business could receive a greater portion of other assets instead of receiving interests in the business.

In situations where no family members work in the business, it is important for a business owner to carefully select fiduciaries under his or her estate plan to administer the business interests after death. To the extent possible, those trusted individuals (or a corporate fiduciary, if necessary) should be coached about the strategy for administering those interests in the event of the business owner's death. The business owner should also keep his or her estate planning attorney and/or other trusted advisers abreast of business issues periodically, whether or not death appears to be imminent. For this reason alone, if none other, annual meetings with professional advisers remain a helpful tradition despite that they are often no longer encouraged by the governing documents of many modern business structures (as was commonplace when most businesses were structured as corporations).

If a business owner ultimately expects the business to be sold, rather than run for the benefit of his or her heirs, it is generally advisable to do so before death since the business owner will be in the best position to negotiate a transaction with an outside buyer. That said, there is a significant tax benefit for heirs inheriting a business that can help mitigate the potential costs of not having the business owner conclude a sale before death. The capital gains tax on the sale of the business can be eliminated because of the basis step-up at death. This opportunity is lost when a parent sells or gifts the business before death. For a business worth $10 million with virtually no tax basis, this could be at least a $2 million capital gains tax savings under current law.

There are special Pennsylvania inheritance tax and federal estate tax provisions that can benefit the heirs of some closely held business owners. Under the Pennsylvania inheritance tax, there is a complete exemption for up to $5 million of "book value" for family-owned business interests if certain very rigid criteria are met. Under the federal estate tax regime, while there are currently no "exemptions" for business interests per se, there are beneficial tax deferral provisions, with favorable interest rates, if the business interests comprise a certain percentage of a decedent's estate at death.

An important part of estate planning for business owners whose estates will be subject to the federal estate tax at death is to have a plan for generating liquidity to pay the taxes. Life insurance is frequently employed for this purpose. However, it is also advisable to make efforts to structure the business owner's estate to qualify for the federal estate tax deferral and special low interest rate if it might otherwise be a close call because of diversification in the business owner's asset base.

As a final matter, for business owners who have reasonable expectations that the value of their business interests will at least triple before their deaths, or expect to sell the business during their lifetime at a significantly increased value, it is oftentimes worthwhile to shift interests to children (or more likely trusts for their benefit) as a federal gift and estate tax savings matter. The shift can occur by gift or sale and the values typically may be discounted based on lack of control or lack of marketability. If it's very likely that the business owner will continue to own the interest at death, a careful analysis must be made of whether the benefit of the basis step-up (for capital gains tax purposes) would be outweighed by the potential gift and estate tax savings of a planned inter vivos transfer. •

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