Transferring the Family Business to the Next Generation

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All businesses and their owners go through a normal life cycle. Like people, a business has to have a start, go through a growth phase, a maturation and maintenance phase and an exiting phase. A family business can often be complicated because these phases are occurring at the same time for the different generations and owners involved. The younger generation is trying to get a start, and the senior generation probably has significantly different and contrasting personal and business goals. Other siblings involved, or not involved, add additional complications and considerations. Obviously, this can easily lead to stressful business and family situations.

Income and estate tax consequences of various business property transfer strategies add to the complexity in achieving a successful business transfer. An advantage for the buyer may be a disadvantage to the seller and visa versa. A successful inter-generational business transfer has to meet each family member and generations' goals while at the same time minimizing the total income and estate taxes paid for the family as a whole. As a result of the current tax law signed June 7th, 2001 by President Bush, gift tax and estate tax planning became more complex and changes on many plans should be considered.

Family business members need a basic understanding of these issues to improve the ability to communicate within the family and to outside professionals who may be providing assistance at various stages.

Talk to One Another

A first critical step for the family members, including spouses, is to have open, honest, and continual communications. Many times family members simply do not talk to one another about what their goals are and how they might be accomplished. With effective communication, family members gain an understanding and appreciation for each other's goals and possible strategies and methods. Family members may discover that the personalities and goals are different and (or) finances are such that the likelihood of continuing the business beyond the current generation is not desirable or feasible. The decision may be to maintain existing business size with junior seeking outside employment until "dad retires". What are other family member's thoughts and aspirations? Do the children who have left the farm want to come back? What are their expectations on inheritance issues? What would mom and dad like to have happen? Is the next generation really interested in the business ownership lifestyle? It certainly is useful for all involved to have some level of understanding on these and other individual family members' goals.

Financial Involvement of Younger Generation

It is desirable for both generations to have the junior generation become financially involved early. There is a heightened awareness, interest, and experiential learning when your personal financial "well-being" is directly affected by management decisions, capital investments, weather, prices, and other factors occurring in the business. Junior will have more enthusiasm and ambition critical the business at a younger age, but may lose this drive, as he/she gets older and more comfortable "drawing a salary or working for wages". Junior should be involved and make decisions, while the senior generation is "still around" to minimize highly risky and wrong decisions that could destroy the business and (or) family.

With profitable businesses and larger estates, spreading the profit over more taxpayers and reducing the comparable size of the senior generations' estate can substantially reduce income taxes and estate taxes and preserve family wealth. Commitments, opportunities, and expectations are more clearly defined when documents are drawn and signed indicating financial obligations and responsibilities.

Ownership of Assets

The junior generation probably does not have the financial strength to own (buy) a high percentage of all assets, but as discussed above, it is important to be significantly involved financially. The senior generation often does not want to give up control of the assets that they have spent a lifetime accumulating, particularly real estate. The future success of the business depends directly on the "working assets" including inventories, and machinery. Therefore, these "working assets" are often the first assets to transfer to the junior generation. It is better for junior to own (buying or lease-to-own) 50 to 100% of these "working assets", versus 5 or 10% of all the assets including land and buildings (if using a partnership or Limited Liability Company transfer tool, have the partnership or LLC buy these "working assets" from Senior and then have Junior own 50% of the partnership or LLC). This leaves the buildings, land and other real estate in full ownership and control of the senior generation. Cash or share rents can be established for the use of these assets and provide income to the senior generation. This provides flexibility, income tax savings, and future income for the senior generation.

Over time, the real estate can be transferred to junior depending on goals, financial situations and income and estate tax considerations. The best time to transfer may be at death of the parents. "Options-to-Buy" and/or provisions need to be made in Wills and Trust agreements to give the junior generation an appropriate opportunity to obtain ownership/control of these assets, particularly for those assets that are an integral part of the operation.

Profit
Obviously, the business must make sufficient profit to provide a reasonable family living for both the senior and junior generations and still allow for business growth. Without sufficient profit, goals are not met, people become unhappy, family structure is lost and business succession is not achieved. Monitoring only cash flow (taxable income) most likely will be misleading. Real profit and "earned net worth change" may be much higher or lower than taxable income. Meaningful accrued income statements showing the actual profit of the businesses and balance sheets for both Junior and Senior should be maintained each year and shared with family members involved in the business. Annual adjustments to rents, leases, wages and other flexible payments can be made as feasible and appropriate. For farmers, the MSUE Telfarm record and business analysis system, utilizing income tax records, accrual income statements, cash flow statements, and net worth statements, is designed to help producers make and monitor financial and management decisions on the farm.

Strategies to Save Taxes
Strategies to transfer business assets should first achieve family goals and second minimize the tax implications for the family as a whole. All too often, families and advisors focus strategies only on the income tax issues and perhaps estate taxes. Inventories of supplies, machinery, buildings, and land need to be considered, but probably separately. A balance sheet with both market and cost-basis values and with detailed listings of assets becomes an effective communication device for family members and professionals assisting with the transfer. It is essential in helping to understand what is being transferred and to develop the best strategies to minimize taxes. Both income taxes and estate taxes need to be considered.

Inventories and other current business assets can be sold with a bill of sale. This unpaid bill can be paid over time depending on cash flow and tax considerations. Depending on goals, financial situations and tax implications, often these assets are transferred using gifting strategies.

Machinery sales are subject to depreciation recapture (ordinary income tax rates) in the year of sale, even if the money is not received. Therefore, when there is substantial recapture, a "lease to own" transfer method is often used. The rent expense is a regular business expense and the income to the parents (if the parents are not a partner or member in the LLC that rents the machinery) can be unearned ordinary income, taxed similarly as interest income, saving Social Security tax.

Land sales are taxed as long-term capital gains (for the gain above the basis and held 5 years) and the installment sale method can be used. But, the buyer cannot deduct the purchase price, only the interest on the debt. Even though interest may be the major portion of payments during the early years, this transaction will probably lead to increased taxable income for the family but the strategy may help achieve family goals.

Until the year 2010, assets that are obtained through an inheritance receive a "stepped-up" basis to the value passed through the estate (usually fair market value). Depreciable assets can then be depreciated (again) from this value creating a substantial tax savings. Depreciable assets include machinery, breeding livestock, buildings, and most improvements.

Under the new law, this "stepped-up" basis would be limited once estate taxes are completely repealed in 2010. A decedent's estate would be permitted to increase the basis of assets transferred by up to a total of $1.3 million. The basis of property transferred to a surviving spouse can be increased by an additional $3 million. Thus, the basis of property transferred to a surviving spouse could be increased by a total of $4.3 million. However the new estate tax law, passed in 2001, reverts back to prior 2001 rules in the year 2011 without an act of congress.

Conclusions

There are many considerations when transferring the family business to the next generation. Successful transfers take several years to develop and successfully execute the plan. The size of the estate affects the strategies that should be used. Families need to start early in this planning process. Usually this is only done once in a lifetime, so carefully developed strategies are important. The results of an effective transfer can be very rewarding financially and emotionally for both generations. Assistance from professionals who work in this area and understand family and business issues are recommended to help family members have the best possible chance of reaching their goals.