Dividing Family Businesses Fairly

Three places to look beyond pro rata arrangements.

BY JEFF PANNELL

THE DREAM of many business-owning families is to pass the enterprise on to the next generation and see it invest its collective talents in growing and developing the company. In many cases, some or all of the children will show the aptitude and interest to step into Mom and Dad’s footsteps. However, not all children will share the same degree of enthusiasm.

Even if not all the children will be directly involved in the family business, parents typically want them to have a fair share of the assets. The question becomes how to divide the family business fairly among participating and nonparticipating family members. The simplest way is pro rata, giving everyone an equal share of each and every family business related asset.

However, this is not the only — or even always the best — option available, especially when there is unequal interest in running the business itself. In most cases, by the time these issues come up, estate tax issues may also rise to the forefront. How current and future businesses are operated and owned can have a significant impact on the amount of tax owed upon the death of the parents. Given that estate taxes must be paid in cash to the Internal Revenue Service and Washington state, the business’s viability could be at stake.

There are three key places to look when considering non pro rata ownership structures for family businesses: current operations, real estate and potential future businesses.

CURRENT OPERATIONS

It’s fairly common for parents to transition management responsibility to the children who are more active in the business while continuing to use pro rata ownership structures for the business itself. The family members in management might very well receive bonus compensation for performance like any other executive, but they might not have a larger share of equity ownership. Depending on family dynamics and business realities, some families choose to give family members who are company officers additional equity ownership based upon the presumption, at least in part, that the additional equity would be granted in like nonrelated businesses.

REAL ESTATE

Assuming real property owned by the business is capable of generating income or growing in value, it can be a good choice of asset to offer children who do not participate in day-to-day business operations but still deserve a stake in the family’s success. One challenge is splitting the business’s total value equally among siblings, even though they own very different assets that are valued in different ways. Also, how businesses and real estate change in value over time vary significantly, so it is very important to look at future scenarios.

FUTURE BUSINESSES

A child who is not interested in participating in managing the existing family business might like to run another business, whether it’s a spin-off from the family business or an entirely new venture. In this scenario, it’s critical to consider the degree of parents’ ownership in the new business and the effect it may have on future estate taxes. In general, and solely from an estate tax perspective, the less the parents own at the time of death, the better. New business ownership can be structured so it doesn’t show up on the parents’ financial statement when they pass away and they don’t have to worry about transferring it as a gift during their lifetimes. One simple way to accomplish this is for the parents to fund the new company using a low interest loan. Ideally, the new venture’s owners retain all the equity appreciation after repaying the loan to Mom and Dad over a period of time using a currently very low interest rate approved by the IRS, and the estate is shielded from excess additional taxes.

In family businesses, perceptions of fairness carry more weight than in the everyday business world. With open communication, the right ownership structure and a bit of imagination, families can keep more of their assets, reward children’s talent and effort, and maintain harmony.

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