FAMILY BUSINESS INSTITUTE

Hello, this is Wayne Rivers at The Family Business Institute. Thank you as always for tuning in. Please follow us on social media. Click on the icons. Also, we always enjoy to get feedback from our viewers who like to push back sometimes or like to agree. Either way, we're fine with it. We just like to hear from you.

This week, I want to talk about four potentially fatal flaws in your family business estate planning. Why is this important? Now, I'll say 30 years ago when I started with family businesses, the state of estate planning was abysmal, and the people didn't have wills and trust. It was just ridiculous.

Now, I would say, here, 30 years later, man, the legal community has done a great job. The accounting community has done a terrific job of making people aware of why it's important, and now, everybody's got wills and trusts and all this stuff and they're usually quite technically sound. What am I going to bellyache about this week then? Well, let me give you a quick scenario that describes so many of our family businesses out there. Mom and dad now, let's say they started the business. They were in their 30's when they started. Now, they're in their 70's, so the business has been around about 40 years. They started with nothing, and now the business has about $50 million a year in sales and it's worth about $5 million in the fair market, fair market value, about $5 million.

In addition, they've got real estate, most business related, but not all. They've got a nice home, maybe a vacation home. The real estate is worth $2 million. They've got other assets like their 401k and investments that's worth $1 million and they've got $1 million of life insurance. If you add all that up, the parents are worth about $9 million. Let's say dad's 75 and mom is 74, so they've had a good working lifetime. Well, lightning strikes, holy moly. Dad has some fatal event and dad checks out. What happens in terms of the estate plan? Well, because we don't want to pay any estate tax, so everything goes to mom either outright or in trust. That's fine. That's the way most lawyers draft it up, and technically it's quite sound.

Then mom survives for a period of years. Then when she dies, things go to the children equally. Let's say in this case, they have three children, a couple in the business, one outside of the business, but that's also a very typical fact pattern. That's the layout of the family and their assets. It's a technically sound plan. It should avoid all the state tax. It should allow for a fairly simple and direct passing to mom, so she gets the benefit of the assets for her surviving lifetime. Her security is not impaired in any way. In that sense, again, a very technically sound plan.

What am I going to bellyache about? Well, there are four huge flaws in this plan that to me make technical sense from an estate planning point of view. It makes zero sense from a practical and family and business point of view. The first problem is mom doesn't want the business. Well, that's pretty bold statement there, Wayne. I mean, how do you know this with your big brain? I mean you don't know anything. Look, we've done thousands and thousands of family interviews over the years, and I can tell you 95% of the time, the surviving spouse, whether it's the mom or the dad, if that person didn't live and breathe that business every day, he or she doesn't want it.

They want the economic security the business produce, yes, but they don't want to actually be in charge and have to operate a business and deal with all the things people have to deal with, and then potentially referee among the employee children and all those things. That's not what they want. They want the security, but they don't want the operations of the business. I can almost guarantee that's the case in your family. What's the second flaw? Well, the second flaw is if everything goes to mom for her surviving lifetime, and I'm using mom in this case, but if like most women, she's going to live a really long time, she's going to live another 20 plus years beyond her husband's untimely death.

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By this time, how old are the children before they actually own the business that some work in and some may not? They'll be 65 or 70 or 75 themselves by the time they own the business, so they work, work, work, work for something they don't even own. Their incentives are all wrong. It just creates a host of problems. I could go down this path for half hour. Don't get me started, all right? Now, following on with that, what's another problem? Well, if the kids work productively in the business after dad's demise, but during mom's surviving lifetime, they have the potential to build up the value of mom's estate, where this technically sound plan now suddenly is subject to estate tax.

The business is worth, let's say, $5 million today, but the kids worked really productively and it's worth $15 million at the end of mom's surviving lifetime. Guess what they've just done? They've created an estate tax problem. They literally have to pay a tax to liberate the business they've been working in all these years from an estate. That to me is just a huge problem. Not to mention the people in Washington could change the tax laws with the stroke of a pen, and make them more onerous the way they were, gosh, 30 years ago that the estate tax laws were ridiculous. Today, they're much better, but the politicians can change them again.

All right. Now, what's the fourth law? The children inherit everything equally. Well, two things about that. Number one, most likely, they're not equal in the context of the business. We know you love your kids equally. I love my kids equally, but in terms of their business capability, they're not equal. There's two pathways there. One, push more of the business interest to the people that work in the business and operate the business and let other family members be compensated with other estate assets, or the second way, and either way works if you have the right fail safes in place, let the business go to all three equally.

Just make sure you're protecting the employee and majority owner, youngsters, from the minority and the minority from the majority. As long as you have rules to protect both sides, you're okay. We don't have a big dog in that fight one way or the other, but there should be plans in place to protect inheritors who work in the business from inheritors who don't work in the business and vice versa. My ultimate point here is the health and welfare of your family business should not be subject to your drop-dead plan. It should be the other way around. You should design your estate plan. We call ... I mean, sorry for the in delicacy, but that's what it is.

We think your drop-dead plan should be shaped so that it complements the needs and wishes of your successors in the business and the business itself that lays golden eggs for the family. Love to have your comments. This is Wayne Rivers at The Family Business Institute. Thank you.

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