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Estate Planning Is Vital for Family Business Owners

Take steps now to secure your future while mitigating taxes on your estate

Key takeaways

- Proper planning can help ensure that your business is preserved for future generations and that you are your spouse live comfortably after you retire
- A number of tools are available to help you protect your firm's future, reduce the size of your estate, and mitigate your tax obligations
- Strategies include stock redemption, special-use valuation, discounting stock, limited partnerships, and trust planning, to name a few

You've worked long hours—month after month, year after year—to establish and grow your own family business. In fact, perhaps you've worked so hard that you haven't had much time to plan either for the business's future, or your own.

But the good news is that proper estate planning can help ensure that your business is preserved for future generations and that you and your spouse live comfortably after you retire. A number of tools are available to help you protect your firm's future, reduce the size of your estate, and, thus, lessen your tax obligations.

Stock redemption

The interest that you have in your business will be included in your estate for tax purposes. Section 303 of the Internal Revenue Code (IRC) allows a business owner's estate to sell shares back to the corporation without adverse tax consequences. When an owner dies, if the value of the business owned by the decedent exceeds a defined percentage of his or her own estate, the company can redeem, or buy back, stock from the owner's estate to the extent that it will cover transfer tax liabilities and administration expenses. Using the redemption avoids adverse income tax consequences and provides liquidity to the estate.

Special-use valuation

This is another tax benefit afforded owners of a family business. Often, the Internal Revenue Service (IRS) will value real estate in terms of its highest and best use—that is, what the real estate would be worth if sold at current market prices. But companies that own real estate that is used as part of the business can value the property according to the purpose it actually serves. Special-use valuation is especially beneficial to businesses that own an asset, such as a warehouse or a parking lot, that is located in an area where real estate values are soaring. Of course, this option is available only if requirements prescribed by IRC Section 2032A have been met (i.e., the value of the real property must represent 50% or more of the adjusted gross estate).

Discounting stock

Asset valuation also is important when it comes to stock in a family business. It is easy to determine the value of shares in a publicly traded company, but the situation is different with closely held companies whose stock is not readily marketable. The good news, however, is that owners of family businesses are frequently able to take a discount on shares when they transfer ownership of the company to their children in order to reflect the lack of marketability and lack of control, per IRS Revenue Ruling 93-12 and Revenue Ruling 59-60.

Limited partnerships

Another way to save on estate taxes is to transfer ownership of the company to a limited partnership, transferring, in turn, minority interests in the partnership to family members. Once again, the value of the transferred interests can be discounted to reflect lack of marketability and lack of control, and can remove future appreciation in the value of the business from the family business owner's estate. This approach can be used even if the family business is set up as a corporation and can remove or reduce future appreciation from the owner's estate tax base. For example, if the family business is worth $1 million today, but is expected to be worth $5 million in 10 years, transferring ownership gradually means the owner will pay estate taxes on a lower value.

The charitable remainder trust

This estate planning option, per IRC Section 664, allows an owner to unlock appreciation in a business and minimize capital gains tax, while making gifts to charity. An owner can place a portion of his or her assets in the trust, which will provide a certain level of income annually to the owner and his or her spouse. Since the trust itself does not pay taxes, it can sell company stock and no capital gains tax will have to be paid. The owner also benefits by having an income tax charitable deduction. At the owner's death, the assets pass to charity.

Whatever strategy works best will depend on your particular situation and plans for the future of your business. It's important to consult with your advisory team well in advance of your plans to move on to the next stage of your life.

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