

FOCUS ON FAMILY BUSINESS

Savvy estate-tax strategies for family business owners

By **MICHAEL JOYCE**

Special for Lehigh Valley Business

Protecting heirs from excessive estate taxes as well as familial discord are significant concerns for owners of family businesses.

As owners begin to age – and aren't we all – they should carefully develop their estate tax strategy, making sure to educate heirs to take advantage of all savings mechanisms available, while simultaneously avoiding interpersonal pitfalls when passing the business to the next generation.

Family business owners would do well to remember that their business is illiquid and, in the event of their death, will be taxed as part of the estate.

For 2017, the Internal Revenue Service requires the filing of an estate tax return

(Form 706) when the combined gross assets and prior taxable gifts exceed \$5.49 million for an individual. And since a deceased spouse can pass his or her unused exemption to the surviving spouse, a married couple is able to protect \$10.98 million from federal estate and gift taxes.

WHEN LIQUIDATION TAKES TIME

To decrease the odds that heirs will have to sell their family business at fire sale prices in order to pay their estate tax debt, they can take advantage of a discount available for lack of marketability, which applies to illiquid assets such as a family business, commercial real estate, family farms, art, antiques and collectibles.

Heirs who inherit illiquid assets such as commercial real estate, for example,



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PROTECTING YOUR ESTATE

With knowledge of estate tax discounts, careful planning and a clear understanding of the next generation's feelings regarding company participation and shares, a family business owner can be confident he has best protected his estate for future generations.

will not be able to sell that real estate as quickly as they would be able to sell a liquid asset such as stock.

They will need to find a willing buyer – which can take some time. And since value is in the eye of the beholder, chances are buyer and seller will have differing views on valuation.

VALUATION EXPERT

Luckily, those who inherit illiquid assets can take a lack of marketability discount on the value of the inherited estate, which decreases the amount of estate tax owed.

Since circumstances differ for every illiquid asset, there is no set discount amount.

Determining the value of an illiquid asset can be highly subjective, but a valuation expert can help beneficiaries determine a reasonable discount to claim for an inherited illiquid asset.

In general, the lack of marketability discount for a business entity that has predictable cash flow will be lower than the discount for a business with less consistent cash flow, since these businesses would be less desirable and, therefore, less marketable.

INCENTIVE TO WAIT

Once business owners consider the estate tax ramifications for illiquid assets, they should strategize to mitigate interpersonal drama when passing the business to the next generation.

Sometimes, members of the next generation grow tired of waiting for the owner to

please see **ESTATE TAX**, page 15

An owners' agreement on buy-sell will do everyone well

By **CYNTHIA MERRITT**

Special for Lehigh Valley Business

There are many issues to discuss in a family-owned business, but the one most often overlooked is the drafting of a buy-sell agreement.

A buy-sell agreement is a contract that links the owners of a business together and controls how and when owners may sell their respective interest in the business.



Merritt

The most common way to fund a buy-sell agreement is a combination of insurance and promissory notes.

Why do you need a buy-sell agreement? You have to ask: "Upon

the death of an owner, do you want to do business with his or her spouse or child, who may not have any knowledge of the company?"

If the answer is no, you need a buy-sell agreement.

TWO BASIC TYPES

There are two basic types of buy-sell agreements, which address most change-of-life events (divorce, disability, death, retirement, etc.):

- Stock redemption agreement, when the business itself buys the stock.
- Cross-purchase agreement, when the

remaining owners buy the stock.

Both have advantages and disadvantages.

The stock redemption agreement does not give a step-up in basis to the remaining owners, whereas the cross-purchase agreement does.

If the buy-sell agreement is funded by life insurance, a stock redemption will need only one insurance policy on the life of each owner. In a cross-purchase agreement, multiple insurance policies may be required.

In a situation with multiple owners, the stock redemption agreement is normally used because of the simplicity of implementation and the reduced costs of the insurance.

IT'S IN THE DETAILS

The buy-sell agreement should address all important change-of-life events. The agreement details how to address the death, disability or retirement of one of the owners.

Most buy-sell agreements restrict the stock transfer to either the corporation or the existing owners.

This is very important if your business is an S corporation, since a transfer of shares to a disqualified shareholder may terminate the S election.

A buy-sell agreement also should define termination of employment and subsequent disposition of shares because of dis-



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The retiring owner wants the highest value for his shares, while the buyer wants to pay the lowest possible value.

ability. Many times, the business or shareholders will acquire disability insurance to provide funds to buy a shareholder's shares upon his disability.

PRENUPT MAY BE WISE

A well drafted buy-sell agreement also should address bankruptcy and divorce.

A personal bankruptcy or divorce may trigger a sale of shares back to the business or other owners.

However, in the event of a divorce, a buy-sell agreement is not a substitute for a prenuptial agreement.

If you inherited a business, started one prior to marriage or have children from a prior marriage, a prenuptial agreement should be considered.

VALUATION FORMULA

A buy-sell agreement comes into place

most often because of retirement.

When an owner is ready to retire, business valuation can be an issue. The retiring owner wants the highest value for his shares, while the buyer, either the other owners or the business, wants to pay the lowest possible value.

The negotiations in this situation can be eliminated by having the owners agree on how to value the business in the buy-sell agreement.

Many buy-sell agreements have an agreed-upon valuation formula, which in many cases eliminates the need for appraisers.

UPDATES AS NEEDED

A buy-sell agreement should be clear and concise so that all owners understand their rights.

It is essential that the buy-sell agreement be updated as circumstances change.

Spending time with your attorney and accountant to draft a buy-sell agreement is time well spent and may prevent family disputes in the future.

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FOCUS ON FAMILY BUSINESS

Berks alliance tackles the challenges of family businesses

By **JOE McDONALD**

Special for Lehigh Valley Business

Family owned and operated businesses will get a chance to brush up on the latest in the marketplace and learn how to develop strategies to get and stay ahead of the competition at the annual fall forum sponsored by the Berks Family Business Alliance on Nov. 29 in Reading.

Keynote speaker John McElligott, CEO of York Exponential, will discuss disruptive technology and innovation in the workplace, whose motto is "Disruption is here. How you react can make or break your business." His company helps businesses leverage technology.

His insights are more important than ever if businesses are to thrive, said Karen Marsdale, president and CEO of the Greater Reading Chamber of Commerce & Industry.

"We know that disruption is here and affecting family owned businesses, large and small. John McElligott's message of embracing innovation and change is vital to business leaders," Marsdale said. "Attendees will walk away with a new perspective on taking advantage of the opportunity of disruption."

USEFUL RESOURCE

The Berks Family Business Alliance, founded by the Greater Reading Chamber of Commerce & Industry, is a resource serving family owned and operated businesses of all sizes. There are no fees for membership.

The alliance provides diverse programming and numerous interactive opportunities to local businesses.

In addition to professionally facilitated



PHOTO COURTESY OF BERKS FAMILY ALLIANCE

Last year's fall forum of the Berks Family Business Alliance. This year's fall forum is Nov. 29 at Stokesay Castle, Reading.

programs on traditional business topics, the alliance explores the challenges faced by family business owners and employees.

WAYS TO OVERCOME

Virginia Dodge, owner of VA Productions, a Cumru Township-based motion picture and video production company with five employees and \$330,000 in annual revenue, is one family business owner who has participated in the alliance's programs and is happy she did.

Dodge said after one session she gained a better understanding of the inherent challenges of family members working together, and, along with her husband, learned methods to overcome those chal-

lenges.

"Ultimately I know that our employees, surrounding family and friends, our personal life and our business are all going to positively benefit from what I take away from these peer discussion sessions," she said.

'COMFORTING'

Emily Coyle, a procurement specialist at M.J. Reider Associates, also praised the program.

M.J. Reider is woman-owned environmental testing laboratory in Reading accredited by the Pennsylvania Department of Environmental Protection, among others.

"Family businesses are so unique in their special ways, and being with a group of individuals who understand that and can relate is so useful and comforting," Coyle said.

BERKS FAMILY BUSINESS ALLIANCE FALL FORUM

- **When:** Wednesday, Nov. 29.
- **Where:** Stokesay Castle, Reading.
- **Schedule:** 7:30 a.m. breakfast; 9 a.m. keynote speaker John McElligott; 10 a.m. table topic discussions.
- **Tickets:** \$25.
- **Information:** 610-898-7778.

ESTATE TAX

continued from page 14

pass on the business' reins and quit the business prematurely.

One way to incent a child to wait patiently for business shares is to design the shareholder agreement so that if the child walks away from the company, he has to give back his shares at book value.

BEING EQUITABLE

In another scenario, the daughter of a family business

owner wants to carry on in the business, but the owner's son does not share his sister's enthusiasm.

How can the owner ensure fairness in his children's respective inheritances?

One solution is to gift shares in the business to the daughter while putting funds of equal value in a trust for the son.

RETAINING CONTROL

A final note: As long as the owner of a family business remains as the general partner of a limited partnership (or managing member for a limited liability

company), he can maintain decision-making control – even if he has gifted the majority of shares to family members.

This can help shield assets from future scurrilous former daughters-in-law or sons-in-law.

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