Pass It On, Inc.

DREAM ON!

KARL AND EDIE started out working in different worlds: she kept the books and managed the billing for a dentist while he was a construction superintendent for a builder who built good houses for hard-working folks. They had dreams of making a better life, educating their twin daughters, Kelly and Kristen as well as the baby boy, Kris, and looked forward to the day when Karl might be given a chance to buy into the business. They never expected to set off one day to start a business, and they never dreamed they would do it together.

The housing market in those days fluctuated between a buyer's market and "everybody has a new truck," but Karl's employer relied heavily on pre-solds so they kept busy through the cycles. Karl began to get involved in customizing their product and discovered he had a knack for unique design ideas that built more profit into smaller houses, and KEy Homes was born. When Karl decided to go entirely on his own, it was with fear and excitement.

Edie joined Karl as they began to get more requests to build and the need for office and bookwork became obvious. The children weren't in school yet, so Edie worked evenings, weekends and two mornings a week when her sister could watch the kids. In less than a year they hired a full-time secretary and two job foremen so Karl could focus on getting new contracts and negotiating with subs. Edie took the books home and did her best to keep up, but eventually they hired a bookkeeper, and she retired from building other peoples' homes to concentrate on building her own home and family.

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Life goes on, and over the next twenty-five years the business grew and prospered. The family did too. Kelly graduated from law school and moved across the country to join a large firm in Philadelphia. Kristen became a teacher, got married, and presented Karl and Edie with their first grandchild. Kris finished a business degree and worked for a couple years in a management-training job, but he just couldn't seem to get the sawdust out of his blood.

It's been five years since he started back in the business, and now he's virtually running the commercial division and is involved in marketing for the entire company. Most of the 30 or so employees feel that Kris will grow into a good boss some day—if his dad isn't too hard on him- and they hope the company will continue to grow. Last year was their best year, with the company clearing nearly $1 Million of after-tax profit and bonuses were good!

As is often case, the accountant for KEy Contactors, Inc. dragged Karl in to see me after he had worn him down for several years with horror stories about families who ignored the problems of business succession and estate taxes. I asked Karl the critical but simple question that initiates most planning "What will happen to this business when you can't own it any more?" His answer was standard for a family business owner and clearly revealed the universal lack of understanding of the process that begins with the death of a sole owner. He said, "I want my wife, Edie, to take over initially. She'll need the income, and she knows what to do because she helped me start the business. Eventually, I want all three of my kids to own the business equally, but I want Kris to have control because he knows the business and has worked hard to earn the right to take my place." Well there are a couple of serious problems with Karl's current plan, so let me share them with you just as I did with him.

The irony is that the very asset that the family wants to preserve creates the greatest tax problem and often must be devastated to satisfy the tax. Few businesses can survive a cachectomy under estate sales terms.

First, it is highly unlikely that Edie will be able to justify the same amount of compensation from the company that Karl took if, in fact, Kris and the key employees are really running it. As is often the case, Edie expressed a strong disinterest in trading her current life for Karl's job, yet she too was concerned about her ongoing income. Furthermore, the IRS has a disturbing name for the income a person takes from a company primarily because of their stock ownership, not because of services rendered. They call it a DIVIDEND—*which we all know is the worst money we can take out of a business because we pay tax on it twice (C-Corporations only).* "Ok," said Karl, "then I'll just leave the stock to the kids and Kris will have to see to it that his mother has enough money to live on." Good answer, but there are more problems with that approach.

The first is a practical issue: the stock control will land in the wrong hands-with the children who are not involved with or knowledgeable about the business. This creates a virtually worthless asset for them because the only way they can realize any financial benefit is once again by paying out *DIVIDENDS.* Beyond that, they will have no real idea of the daily operation nor the financial status of the business and will most likely never see any value unless the business is forced to liquidate or is sold. Neither outcome is on Karl's preferred list of results. For Kris, the situation is worse and may be unacceptable. He will be expected to do everything in his power to maintain the stability and profitability of the company while he basically reports to a committee made up of his sisters, their husbands and potentially their children or the attorneys. He will be forced to take an active role, if allowed, in their estate planning to reduce the possibility of the stock flowing into the hands of an ex-spouse's future mate or a bank representing the interests of minor children. Even if they let him manage the company on a daily basis, he may be prevented from capital expansion, borrowing or negotiating a buyer without full agreement from all the shareholders. Most likely, just when he sees a profit picture that justifies growing the company, his sisters will begin to inquire about when exactly they can expect to see some income for their hard-inherited stock.

The really critical problem is that a business this successful will attract the attention of the IRS before the stock can ever be transferred to the children. You see, the IRS has an unfiled mortgage that often captures between 40% and 50% of everything we own in the form of a transfer tax that must be paid before we can pass the assets on to the next generation—and they only take cash! Many times a family is forced to upwrap the working assets of a business, selling them under duress, in order to raise the amount of cash required to pay the tax. The irony is that the very asset that the family wants to preserve creates the greatest tax problem, and often must be devastated to satisfy the tax. Few businesses can survive a cashectomy under estate sale terms.

The solution for Karl's dilemma is relatively simple. We designed a guaranteed buyout between Kris and Karl that provides the cash to complete the purchase through the use of life insurance funding.

Let's review the impact of this solution on the problems we previously outlined.

- Kris buys the stock from Karl's estate at his death, which replaces the full value of the business with cash that Edie can reinvest to produce the amount of income she will need. She will not be a creditor of the business nor will she have to rely on its success for her future security.
- Kris gains full control of the company in very short order. There is no waiting for the estate to close, no selling of assets to raise cash, and no tension that his mother's entire financial world depends on his ability to run the company. He can play with this own chips, so to speak.
- Kelly and Kristen receive their fair share of whatever inheritance they might otherwise have received, but it will now be in cash or the investments their mother decides to purchase. As she gets older, she can choose to make gifts to them that are useful rather than being restricted to the stock with all its inherent disadvantages.
- Finally, this plan postpones the estate tax until Edie's eventual death. If we've adequately provided for her needs with the income from the original proceeds, they should be relatively intact to pay the taxes due at her death and can be maintained in a mostly liquid form. The business is no longer part of the estate and may have been removed at a far lesser value than if it had remained and grown in Edie's estate.

You probably think that Karl and Edie don't exist, but in fact, they exist in dozens of our case files and thousands of family businesses in our city. A **funded family buyout** is not the only solution, but it is the most dependable because the event that creates the need creates the cash. We can design a similar plan for almost every business situation, including a key employee buyout where there are no children in the business and not likely to be. *"No planning"* can produce a nightmare—*"good planning"* can make dreams come true.

Don See is a Chartered Life Underwriter who specializes in the design and funding of business succession and estate plans for families that own companies.

Reprinted from "Pass It On", a newsletter, provided for clients and friends of Pass It On, Inc.

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