Estate & Family Legacy Planning

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Family Business Planning

DUE DILIGENCE WHEN GIFTING FAMILY BUSINESS INTERESTS (& UNDERSTANDING BUYING HABITS)

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We are all guilty of the same poor buying habits when walking into a supermarket resulting in some not-so nutritious purchases. Researchers know these bad habits. And of course, so do the supermarkets who are selling us their products. For instance, although most of us know what we want to buy even before we enter those sliding doors we often walk out with other purchases-some of which we probably don't need at home. Here's why: unless you are laser like in knowing what you want to purchase it is very easy to get distracted with all the other items at your fingertips. For instance, the most expensive items to be found are at eye level, commonly purchased items are found in the middle of any aisle-walk a further distance and you go past more products to buy; and of course those products at the check-out counters are there for a reason-they might not be good for your health but they register a lot of sales! And hard to believe, but retailers even know that left to their own devices shoppers tend to veer to their right as they shop!

Bottom line as one expert noted: "The more mindless you are when you shop, the more you are going to be poked and prodded to buy the manufacturer's products."[1] Of course, the problem with these purchasing habits is that it is not likely to be good for our health (or pocketbooks) despite our willingness to pay for them.

So what is it about this human behavior that has captured our attention as advisors dealing with families and their business enterprises when they seek out legal services? These facts about shoppers caught our interest because such behavior also relates to business families and their behavior when purchasing legal services to assist in the transfer of their family's capital.

It never ceases to amaze us when a family business dispute ends up on our desks. Inevitably in discussions with the family it is revealed that some of the estate planning worked-the tax planning hit the basic objective, or so it seems, by having the business interests pass to the next generation thus reducing or evading estate taxes altogether. Unfortunately, such planning fails the more critical test of keeping the family together and focused on the growth of their businesses. Upon reflection it is invariably revealed that prior services provided to these families were indeed superficial and lacked any due diligence in analyzing the pros and cons of making and structuring the contemplated gift, including any discussion about trust governance and vetting possible fiduciary conflicts of interests. Rather, the family went ahead and simply purchased a tax strategy.

So before spending time and money on legal services for structuring gifts of business interests, a set of criteria would be useful for families to employ with their advisors, much like the nutritionists who are trying to nudge the human behavior of us shoppers into more healthy purchases. For shoppers, one thoughtful approach that seems to be working is placing a mirror in the entrance of the supermarket so that people can see themselves (their waistlines?) before spending their money!

So enter the patriarch or matriarch of a family business walking through the doors of a law firm thinking that he or she wants to make a gift of business interests. They know they have an illiquid, taxable estate and they feel the pressure to do something. Well indeed, they have walked into a supermarket (of sorts).

THE WHY

All clients need to pause and understand something before walking into a law office. Part of the practice of law involves selling services, and when presented with a problem, attorneys can usually craft a solution.[2] Why is this important to understand and what is its application to human behavior - especially with families who are owners of business interests and are contemplating passing business interests onto the next generation? Part of the answer lies in the fact that if something can be explained, the client(s) might just purchase the advice without making sure that the transfer strategy or advice aligns with their best interests as a family. Many of these diverse family interests may not be immediately recognizable, even to a skilled attorney. Everyone likes straightforward ideas. And, it goes without saying that there can be no perpetuation of a family enterprise without some level of wealth transfer planning.

Thus, one of the first questions that all families with business interests need to ask is the big "Why"-Why do you want make a transfer of wealth of business interests to the next generation? And, just as important, why now? If the answer is merely predicated upon the allowance of some tax objective; i.e. that the clients have the available gift exemption or that some type of tax acronym (IDGT, SCIN, GRAT, etc.) can be implemented, then the clients should hit the red pause button.

Rather than focus on the techniques of how something is transferred, the "Why" should be the first question the family and its advisors need to address. Why is it important to the family to transfer business interests? The answer to this question might be found in an obvious, but often overlooked place. Much research has shown that those business families that have endured and prospered over many years have addressed, in writing, a fundamental sense of purpose and shared vision.

Tackling the Why question, one well-respected author states:

"Enduring family businesses work very hard at defining a Sense of Purpose... They ask and discuss such questions as: Why are we doing this? Why are we working so hard?...Why are we spending the time to develop policies? Why are we exerting so much energy to prepare for the future?...".[3] This sense of purpose, a navigation system if you will, will give meaning and direction to the perpetuating of your business interests.

Our advice to all clients: Step number one is addressing the big WHY and articulating it in writing. Worry about the how thereafter.

HOW

This overlooked question is not about how a transaction will be structured, or the techniques or strategies employed. The HOW focuses on process. How will the family be making their planning decisions? Closeted away with any one of your advisors? Or, employing a team approach and including other advisory inputs into the process.

The reality is that rarely will one advisor have the multi-dimensional skill set necessary to deal with many of the non-tax issues that saturate these family businesses, including financial, governance and often deeply rooted emotional discussions about issues such as what's fair and who is entitled to what. In order to best serve the family, financial advisors must abandon their supply-side, product-centric methods of inquiry in favor of a deep listening and probing approach that focuses on needs

identification. Many distinguished family business consultants have long argued and concluded that effective collaboration is a primary ingredient enabling families to perpetuate well-being across generations. However, because of historical buying habits of consumers how they purchase legal services, the family may not know of or immediately understand the value of this collaborative opportunity over their tendency to compartmentalize advisors and simply buy products/solutions.

Of course, there must be a belief system in the family and its advisors in the value of collaboration. The strength of this belief can partly be assessed on the basis of whether the family values a marginally higher investment in getting to a comprehensive and well vetted plan where the return may be only measure down the road in terms of avoiding family or financial ruin and not simply its denomination in some sort of tax savings.

Our hunch is that families don't believe in collaboration mainly because of their buying habits-they have rarely seen it utilized or offered as a service, and are used to paying for advice which unfortunately does not get properly critiqued by different professionals who might have different values to add to the process. Education about this is key, and not just for families: "Educating both the family and the advisory side about the need, realities and value of collaboration is an important venture in itself" and will lead to substantially better answers to "why" questions raised above.[4]

WHEN

When to start a gifting or transfer program might be seen as a somewhat redundant question. After all, what matriarch or patriarch of a family business would want to opt for transferring equity in a business to the next generation without some clear, unified consensus from the family addressing the Why question. Unless the children themselves answer the Why question in such a fashion that is beneficial to them, the family and the enterprise, then the result might be to simply opt to sell the business.

But assuming for a moment that a family has indeed answered the Why and How questions to the satisfaction of the founding generation, then the WHEN needs to be addressed.

We ask this question because we find that all too often the matriarchs/patriarchs feel compelled to do something further, i.e. to make simultaneously transfers by gift or sale of some of their equity interests in the family enterprise while "the iron is hot." Some of this pressure admittedly stems from many different professionals advocating such ideas in the hopes of selling more complex services or products.

But such analysis misses the point. At the heart of most, if not all estate planning is the word "de-capitalization". Transferring your wealth, even those beloved interests in your family business - is taking something off your balance sheet. You will be poorer! At certain points in time this needs to be done if the business is indeed to get to the next generation. But it does not necessarily mean that just because the Why has been answered it automatically is a green light to make the transfers.

We would argue that the green light is given on When to transfer business interests can be found at a point in time the elder generation is satisfied that the Why and How questions have been thoroughly vetted and that the parents are also emotionally and financially comfortable with getting these interests off their balance sheets.

But even WHEN they are comfortable with this notion of de-capitalization all families need to address to their satisfaction some of the questions raised below. Then the transfers and their structures can be contemplated.

If gifts are contemplated to all children, is there a written and clearly defined way for a child, or trustee of that child's interest, to sell said interest back to the enterprise in the future if they no longer want to be part of the business? Being stuck with highly illiquid business interests without a desire to be part of the enterprise will surely cause disillusionment and resentment later on. Too much time by professionals is spent in a one directional manner of thinking- that of getting something off your balance sheet. But attention also needs to be paid to how a beneficiary (or trustee) can monetize the gifted asset (without being demonized) if they choose not to be part of the family's enterprise.

If gifts or transfers are going to all children, regardless of their interest in the business, will all the children behave in the same way upon receipt of the transfer of the wealth?

Will gifts of business interests to all the children unite them or serve as contaminated fertilizer for future disagreements?

We all can agree that if the family enterprises and the parents wealth transfers produces material prosperity and growth of everyone's balances sheets, but the family ends up splintering and becoming fragmented, if conflict emerges among the heirs that ends up on the front page of newspapers, then one would certainly have to question how successful the wealth transfers strategies really were.

WHERE

Are these transfers by gift or sale, in trust or outright? Unfortunately, these all too often come at the beginning of the conversation-driven by tax strategy planning, but really belong at the end. They come at the beginning because that is what the shopper thinks they are purchasing-a simple solution. In reality, we put this last because when the Why, How and When discussions are well formed, the "Where" comes naturally. These prior questions will separate family and business priorities and harmonize them or not. Questions surrounding wise decision-making and sturdy governance, appreciating emerging trends in conflicts of interests between fiduciaries and trust beneficiaries, will provide top-down guidance to whatever structures should be implemented.

CONCLUSION

Buyer beware! The cake looks good and the store wants to sell it, but the stakes are too high in these kinds of planning circumstances to indulge the kind of transaction that feels good now but may forever leave an aftertaste that will simply be unpalatable to the family at large.

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1 Nudged to the Produce Aisle by a Look in the Mirror, by Michael Moss, New York Times, August 27, 2013

2 For a thoughtful commentary of the subject of lawyers as salespersons, see, Christopher P. Cline; "The Fault, Dear Brutus, Is not In Our Stars, But in Ourselves..", ACTEC Journal 34 (Page 33, 2007)

3 John L. Ward Perpetuating the Family Business, 50 Lessons Learned from Long-Lasting, Successful Families in Business (2004), Page 24

4 G. Scott Budge, Gregory T. Rogers, & Brian Douglass. "The Real Work of Collaboration: Are We Kidding Ourselves?" (2010), https://www.raylign.com/uploaded_content/5/17.pdf

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Prior to joining RayLign, Scott founded two companies focused on delivering internet-based management services to single- and multi-family offices, and financial advisors throughout the US and Canada. He was a Senior Vice President at SEI Investments where he co-developed their family wealth management unit and participated in several, multi-year strategic projects. Scott has published several articles, including works on the psychology of investments, family wealth and family businesses, and has served on the editorial board of the Family Business Review. He has also spoken at numerous industry conferences in the US, Europe, the Caribbean and Latin America. In addition, Scott was a founder and member of the creative team at Shaking the Tree Foundation, a professional theater group whose productions focus on challenges faced by families of wealth. Scott is a Fellow at the Family Firm Institute, a founding member of the Money and Family Life Project at the Ackerman Institute for the Family, and holds a PhD in Psychology from New York University. Scott can be reached at (203)-742-5452, or at Scott@Raylign.com and www.raylign.com.

About Smith, Gambrell & Russell, LLP

Since Smith, Gambrell & Russell, LLP began practicing law in 1893, we have pursued a vision of building one of the country's premier full-service business firms. Today we serve corporations and individuals across the globe from offices in Atlanta, Georgia; Frankfurt, Germany; Jacksonville, Florida; New York, New York and Washington, D.C.

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We look forward to serving you with responsiveness, skill and professionalism.

Roy P. Kozupsky is a partner and the head of the Trusts & Estates department in the New York City offices of Smith, Gambrell & Russell, LLP. Since being admitted to practice in 1985, Mr. Kozupsky has worked exclusively as a trusts & estate practitioner. His work encompasses strategic governance planning for large families and their business enterprises and the private wealth planning for these clients and their extended families in the following areas:

1. Intergenerational wealth transfer planning for families and business owners,
2. Philanthropic planning,
3. Complex multi-jurisdictional estate, trust and fiduciary accounting litigation, and
4. Administration of decedents estates.

A significant component to Mr. Kozupsky's practice is family legacy planning for families whose wealth is aligned with their family businesses and provides for strategic planning, consulting, management and administration for wealth creators and their families.

This area of legacy planning for large and complex families and their family enterprises is achieved through extensive collaborative work with other non-lawyer professionals who specialize in family business planning, and is tailored to comprehensive long-range plans which includes mentoring, education and training of family members on how their wealth can both be effectively protected and deployed. Mr. Kozupsky received his B.A. degree from University of Colorado in 1978. In 1985, he received his J.D. degree from the David A. Clarke School of Law. He is a member of the State Bar of New York.