LEGAL AND TAX TRAPS TO AVOID IN A FAMILY BUSINESS

Starting a business with family members or bringing family members into an existing business can be emotionally and financially rewarding. Unfortunately, several legal and tax traps are just waiting to snare the unwary.

Failure to Plan for Succession of Ownership Can Be a Legal Trap.

The term "succession of ownership" is used to identify the people who will own a business after the current owners no longer do. You should plan for the succession of ownership at the earliest possible time to avoid disputes later on. A dispute over ownership can be extremely damaging to a business. Such disputes may be particularly damaging between family members because of their emotional involvement.

When planning for succession of ownership, you should consider every contingency that could cause any owner to relinquish an interest in the business. For example, everyone will relinquish ownership at death. So, the owners should consider whether they want one or more of their heirs to inherit their interest in the business. In the alternative, owner A might want the option to purchase some or all of owner B's interest after owner B dies.

The owners should also decide whether events other than death will trigger a relinquishment of ownership. Such events may include disability, retirement, or voluntary and involuntary terminations of employment.

If the owners decide that disability will trigger a relinquishment of ownership, the duration and extent of the disability should be defined. For example, the owners might agree to sell their interests if they are totally unable to perform their usual work for the business during a 90-day period.

Whenever owners want the option to purchase another owner's interest, the price and other payment terms should be predetermined. For example, you might set a high price for the interest of a deceased or retired owner, a lower price for the interest of an owner who gets tired of the business and simply quits, and perhaps the lowest price for the interest of an owner who is fired.

Tax Traps Exist As Well.

Whenever two or more family members own a business, they face two tax traps. The first trap involves potential income tax, while the second trap involves potential estate and gift tax.

Potential income tax
As a general rule, you are not required to pay any tax if you contribute cash or equipment to a business in exchange for an ownership interest. However, the result is different if you only provide services or a promise to render services in exchange for an interest in a business. In that case, you are deemed to have received income in an amount equal to the value of your interest in the business. You are required to pay tax on that income just as if you had received wages rather than stock.

Potential gift and estate taxes
First, some definitions. For this discussion, a "donor" is a person who makes gifts of cash or any other type of property while living and makes bequests when deceased. We will refer to a "donee" as a person who receives gifts from a living donor or bequests from a deceased donor.

Under the Internal Revenue Code (IRC), each year during a donor's lifetime, a donor may make gifts worth up to $10,000 to as many donees as the donor wishes with no tax consequences. For example, during 1994, a donor may give $60,000 to six donees with no tax consequences.

If, during any year, a living donor makes gifts to any donee totaling more than $10,000, the donor has two choices. The donor must either pay a gift tax on the amount exceeding $10,000 or utilize an IRC provision known as the Unified Credit. Essentially, the Unified Credit allows you to defer the payment of gift taxes until your death. In effect, you avoid paying gift taxes while you are living, but upon your death your estate taxes are increased.

If you make a gift of an interest in your business to any family member, the gift tax rules discussed above will apply. Thanks to a law passed by Congress in 1990, even if you sell your interest in a business to a family member, you may still have to pay a gift tax or reduce your Unified Credit.

Under the 1990 law, when auditing the sale of a business to family members, the Internal Revenue Service (IRS) may presume that the purchase price is artificially low. If the sale occurs during your lifetime, the IRS could attempt to collect gift taxes from you. If the sale occurs after your death, the IRS could attempt to collect estate taxes from your estate. The amount of the gift or estate taxes would be based on the difference between the purchase price and the amount the IRS deems is the fair market value of the interest that you or your estate sold.

To avoid paying estate or gift taxes, you (or your estate) must convince the IRS that the sale was a bona fide business arrangement rather than a device to make a gift or bequest of your business to your family member. You (or your estate) will have to show the IRS that the transaction was comparable to arrangements typically entered into by unrelated parties. The IRS will look at factors such as the terms of the agreement, the fair market value of the business, anticipated changes in value during the term of the agreement, and the adequacy of the purchase price. You will be best prepared to convince the IRS that the sale was bona fide if you involve your attorney and your accountant in your succession planning.

No estate or gift tax is imposed on bequests or gifts between spouses. Therefore, the estate and gift tax rules discussed above do not apply to transactions between spouses. However, if you are in business with your children, siblings, or any other family member, the IRS may say "Gotcha" if you transfer your interest in your business to them for less than its full value.