Family Business Success: Transferring Wealth in the Family Business Through Use of Real Estate Entities

CONWAY CENTER
for FAMILY BUSINESS

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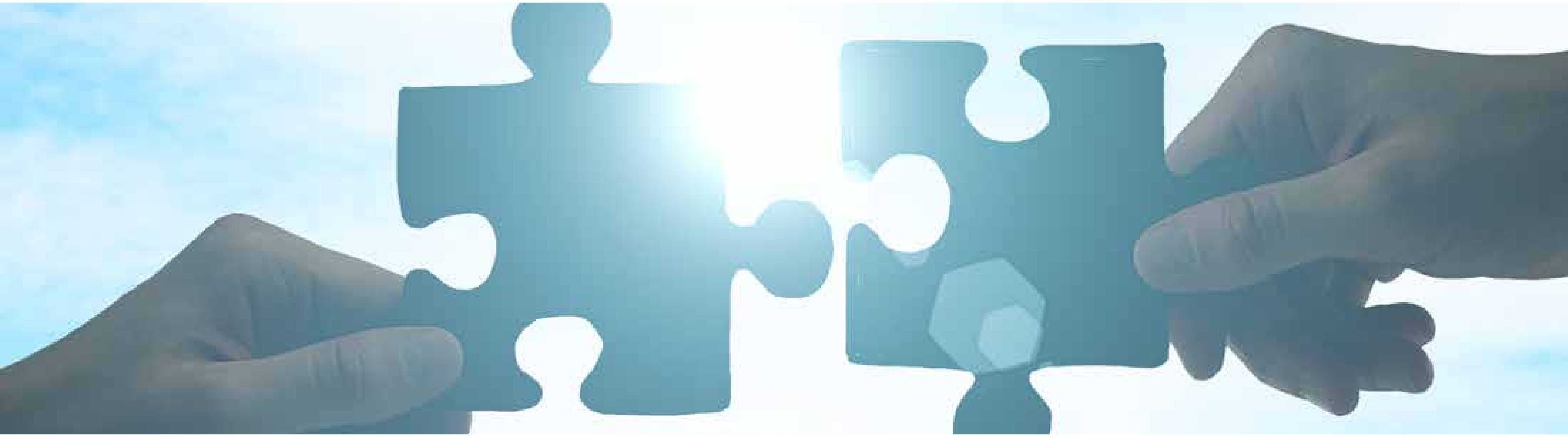
Owners of business enterprises often struggle with transferring ownership of an actively managed business operation to succeeding generations who will not be involved in the operation of the company. One way to partially solve this problem may be through the transfer of passive ownership interests in real estate that is used in the family business.



Transferring the Real Estate

To allocate real estate equity among family members without involving a transfer in the operating business, it may sometimes be necessary to transfer real estate outside of the family business. Unless the business is taxed as a partnership, the transfer could result in some negative tax consequences. Just make sure to consult with your tax advisor prior to making any such transfer.

Once the real estate is held — or has been transferred — outside of the family business, the ownership can be structured as a family-limited partnership or limited liability company, with both voting and non-voting interests. The transfer of the non-voting interests to family members can result in the equity in the business being transferred at a very tax-efficient cost.

Transfer of Interests in the Real Estate Business

Let's suppose a mother and father each own 50 percent of the limited liability company and, under its capital structure, one percent of the interests have voting and management rights and the remaining 99 percent are non-voting interests. Even though the 99 percent interests have no vote, it is important that, under the operating agreement, management of the company is obligated to act as a fiduciary with respect to rights given to the non-voting interest holders.

After the real estate is owned by the limited liability company, the parents can transfer the non-voting ownership interests to children, grandchildren and/or trusts for any of them.

Because these are minority interests in a business controlled by others, an appraiser will value the interests at a fairly significant discount from the enterprise value (a 10 percent interest in a business worth $1,000,000 is not worth $100,000; it may be worth $60,000 after discounts are applied). Thus, a gift tax return will report a value at less than the value of a percentage interest of the underlying assets. It is important that the gift tax value be supported by an appraisal that meets the requirements to qualify for gift tax purposes.

Structuring the Relationship between the Operating Business and the Real Estate Holding Company

For the planning to be effective, the operating business must pay fair market rent for the use of the family-owned real estate. When members of the real estate company are not owners of the operating business, a mechanism for resolving disputes regarding the setting of rent should be included. There should be documentation that the company is paying fair market rent for the use of the real estate. There should also be a mechanism for determining fair market rent upon the exercise of renewal options.

Over the years, as the company pays rent to the real estate holding company, distributions can be made to passive owners of the real estate holding company (whether they are second generation, more remote generations or a trust for some set of beneficiaries). Oftentimes, those working within the family business don't want other family members participating in the ownership of business operations. Instead, those family members can participate as passive owners of real estate that is used by the operating enterprise.

Using real estate to transfer wealth is a tried and true method to ensure that family members not involved in a business can still benefit from the wealth generated by that business.

About Conway Center for Family Business

The Conway Center for Family Business is a membership-driven, non-profit organization providing educational programs and resources to help central Ohio's family-owned businesses grow and transition to future generations.

Our Mission is:

- To help family businesses be profitable and successful;
- To assist family business owners with the transition of their business to the next generations;
- To celebrate the accomplishments of outstanding family businesses within our community; and
- To increase awareness of the positive impact family businesses have on the central Ohio economy.

Family businesses comprise 80 to 90 percent of all business enterprises in North America — and 62 percent of total U.S. employment — yet nearly half do not have succession plans. Family businesses face unique challenges and opportunities in today's economy and the Conway Center can help!

Members enjoy meeting other like-minded family business owners and employees at our educational programs, networking events, annual awards program, peer groups, and more.

Learn more at familybusinesscenter.com.

About the Author

J. Anthony Kington is a partner in Taft's Business & Finance group. Tony focuses his practice on serving the needs of businesses, as well as individuals and business owners, regarding transactions involving the corporate and business law area. This includes mergers and acquisitions, financing, securities, commercial real estate, business succession planning, and estate and gift tax planning.

Tony has a special focus and proven track record acting as general counsel to a variety of businesses and advising closely held and family owned businesses on their unique needs including the establishment of advisory boards, control issues, governance, succession planning and wealth transfer.

Learn more about Taft at www.taftlaw.com

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The Conway Center for Family Business provides educational programs and resources to support the growth and success of central Ohio family businesses.

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