Estate Planning Strategies to Protect Your Family Business During a Child's Divorce

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Building a successful business takes resources and commitment. After pouring time, energy, and financial equity into a business, it's rewarding when your child takes an interest in what you do and becomes a part of it.

Family and closely-held business owners will often gift ownership interests to their child as a way of cementing their equity in the business and planning for a future transition in leadership. Sometimes, the child's spouse also becomes a part of the business, learning the ropes and making meaningful contributions.

But what happens to your business ownership structure if your child gets divorced? Obviously, your primary concern is the well-being of your child and any grandchildren. But the company you worked hard to build could now be in the middle of a potentially contentious situation. How can you protect the company you built while also keeping the best interests of your child in mind?

Equitable Distribution

Some of the most common questions that arise during a divorce when a family business is involved are:

- Will the ownership interest be subject to equitable distribution?
- Will one spouse need to be bought out of the family business or compensated for his or her equitable interest in the business?

New Jersey is an equitable distribution state which means that in a divorce, marital assets, including debt, are divided fairly (which does not always mean equally).

As a general rule, an asset received by way of gift during a marriage is exempt from equitable distribution. However, if that asset grows in value during the course of the marriage as a result of the owner's active efforts, then the growth in value would be subject to equitable distribution. This would apply to a gift of a business that subsequently grows in value as a result of the new owner's active efforts during the marriage. Alternatively, if your child used marital funds to purchase ownership in the business, rather than receiving it by gift, the spouse's marital interest would be greater.

In New Jersey, the exact division depends upon a variety of factors, including contributions to the company's growth or sacrifices that contributed to the success of the company. A forensic accounting firm is usually retained at this phase to value the entire business, requiring the commitment of time and money, which can disrupt the daily operations of the company.

All of these considerations factor into the divorce litigation and will probably result in an obligation that your child will have to pay his or her spouse an amount sufficient to buy out his or her marital interest in the company. If your child does not have adequate capital to make such a payment, he or she may have to negotiate a financed "buy-out" with the ownership interests collateralized to secure the financial obligation. The worst-case scenario would be your child having to sell his or her ownership interest in the company to meet the financial obligation.

Obviously, none of these outcomes is the desired result for your child or your company. So, what can be done differently to protect your business, as well as your child's ownership interests, should your child divorce his or her spouse?

Techniques to Protect Your Estate Should Your Children Divorce

With the 2022 federal estate tax exemption set at $12.06 million for an individual, there are numerous effective estate planning techniques that can be utilized to protect these business interests in the event of a divorce.

Gift to a Trust

Rather than gifting the business interest to a child outright, consider making a gift of such an interest to a carefully designed trust for the benefit of your child and/or grandchild(ren). Since the business interest would not be "owned" by the child at the time of a divorce, it would not be considered an asset in the marital estate subject to division. The trust may also vest significant discretion in the control of the trustee. Thus, the child's interest could be deemed too speculative to be attributed to the child for purposes of determining support obligations. It is important to bear in mind that the use of a trust cannot be implemented by a spouse to defraud his/her spouse of proper equitable distribution of assets which were, in fact, marital assets before they were contributed to a trust. Therefore, it is important to carefully consider the motivation and purpose behind the creation of the trust.

Employment Agreements

It is not unusual for the non-employed spouse to claim that a gifted interest (whether outright or in trust) was given in exchange for the employed spouse's employment efforts. If a child is going to participate in the business on a day-to-day basis, the use of an employment agreement setting forth reasonable compensation could be a helpful tool to deflect a claim that an individual contributed "sweat equity" to the business in exchange for the gifted interest (whether outright or in trust). The employment agreement reflecting reasonable compensation would set forth the actual compensation for the effort of the family member employee for services rendered during the marriage. This would buttress the argument that any interest gifted to a trust was given with detached and disinterested generosity by the donor, rather than in exchange for the services of the employed family member.

Additionally, it may be wise to consider a similar agreement with other family members participating in the business to establish the level of compensation received for their services.

Business In-Law

Introducing family members into a family business seems logical. However, if the family member in the business is a son-in-law or daughter-in-law, we counsel clients to consider other techniques to award the individual effort rather than gifting of business interests. Sometimes, an employment agreement with compensation tied to success (e.g. a "phantom stock" agreement) will provide the necessary motivation for the success of the employed relative without actually giving away an ownership interest.

Legal Counsel for Divorce / Estate and Succession Planning

These are just a few of the strategies that can be implemented as part of an estate and succession plan to help protect your family business in the event of a divorce. Regardless of which tactics are implemented in a plan, the most important difference between a smooth-intergenerational transfer and a bumpy one is an actual plan.

At Einhorn Barbarito, our attorneys advise clients on how to protect their interests from divorce, estate/gift/income taxes, and other circumstances that could hinder the long-term success of the business.

As legal advisors, we know that nobody wants to think about their child going through a divorce, much less plan for it. But in a family business succession strategy, mapping out potential events that could impact the business, such as divorce, is necessary.