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“Taxes, Heartburn and Family Business”

The four Stockton brothers, Charlie, John, Kevin and Dean are members of the “Lucky Sperm and Egg Club.” Their grandfather founded a heavy construction company and it has been passed to G-3, their generation. Soon they will make a similar transfer to G-4, the brothers’ children. For this article, I will refer to the company as “Stockton Construction, Inc.,” however, all of the names are fictional to protect the identity of the individuals. The brothers range in age from 46 to 34. All are graduate civil engineers; two have MBAs and all work in the business. Dean, has his MBA from a prestigious school in France. His combination of being the youngest and holding an MBA in finance is an important factor, as will unfold later.

Stockton Construction builds bridges across vast bodies of water and drills tunnels for subways in major cities. Last year, company profits exceeded \$100 million dollars. Because they are a construction company, they must post substantial performance bonds on each project. This requires them to be very sophisticated in management of their cash reserves. They handle their money very effectively.

When the company transferred from founder to the father of the brothers, it was a cash transaction, not a gift. Tax laws in the US place a limit on how much one can gift to children without paying a tax as permission to make the gift. Instead, the founder sold his shares to his son, with a long term pay out. Essentially, the pay out made the founder even wealthier, with a very generous personal cash flow for the balance of his life. When he died, the remainder due on the purchase was forgiven.

This same method of transfer has been used in moving the ownership from G-2 to G-3, the four brothers, except that the G-3 purchase of G-2 share transaction has been completed because the company is so profitable. Their father is a wealthy man, as was their grandfather, as are the brothers.

Current US tax law makes it efficacious for the four brothers to make outright gifts of Stockton Construction, Inc. shares to their children now. Collectively they have 12 ½ children, age 0 to 17. Each brother can gift \$10mm of company shares to his children. This combined \$40mm represents a minor percentage of the total shares. All of these details are fairly common but it is the interpersonal details that make it complicated.

About Dean: Being the youngest, substantial funds have accumulated in Dean’s account while in high school and college. He worked in the business for a couple of years following college graduation, then got his MBA, worked for a financial institution for 3 years and then returned to work at Stockton. He had the option to choose where he would live. Being a savvy businessman, he selected Texas, a state with no personal income tax. He has 2 ½ children.

About Charlie: There are thirteen years between Charlie and Dean. As the oldest, he was the first brother to work in the business. He moved with the various construction projects and was working in California when he fell in love and married a “California girl.” The only place a “California girl” is *really* happy is in California, and that is where they live. California ranks #3 in terms of the highest tax rate on personal income in the US. Charlie, father of three daughters, is a very affable man but has not had the best record of success in the business. A few years

ago he elected to get into the real estate market, *just at the wrong time*. After taking a substantial loss, he is back in the mainstream of the company serving in an important business development role.

About John: He is second oldest, a classic, driven, Type “A,” person. He is a fine man and has the potential to be a “take no prisoners” type leader. A great deal of the current success of the company can be attributed to him. He harbors some resentment about Dean’s accumulation of money and has said, “I was working in this business for 15 years before Dean came to work.” John’s path was similar to Charlie, for he too found a “California girl” and California is where he lives...same high tax rate. John was and is a competitive athlete and if he doesn’t get his daily “endorphin fix,” he behaves like a caged animal. Like Charlie, he has three children, two daughters and a son. He is building a fine home on the Pacific Ocean. He is co-president with Kevin.

About Kevin: Kevin received an MBA in Paris. When he came back to the U.S., his father conscripted him to return to the sleepy mid-western town and grow into his current role of co-president. Kevin and John receive a very substantial bonus in addition to their industry-appropriate salaries. He has a keen eye about the present and benefits from being pushed to focus on optimum opportunities in the future. He found his bride in that sleepy town and now they have four children.

Now comes the rub: When Dad was running the company, he would direct funds from Dean’s Accumulation Account to Charlie and John, so they would not feel the heavy “bite” from the California tax. He called it “equalization” but I have never been able to establish what was equal. Technically, the Accumulation Account was Dean’s personal property and dad was giving money from that account to the brothers who lived in California. After age 21, Dean had a legal right to direct those funds for his personal use. Dad took the “all in the family” point of view, which he could do when he had absolute control.

Now we have four men, brothers, with different views and different wives. Of course the California residents want the practice to continue while the Texas resident, who pays no personal income tax wants the “equalization” practice to stop.

As if this were not complex enough, in 18 months the brothers will make the transfer of Stockton shares to their children. That means that 8 of the shareholders, Charlie, Mike and their children, will live in California, which begs the question: “Will the equalization continue when G-4 are owners?”

Dean advocates that when G-4 become owners, the practice must stop. After much debate, even heated disagreement, the decision has been made to end the practice when the stock transfer from G-3 to G-4 takes place. Dean was very eloquent when he wrote the following to his brothers:

“We all should have some heartburn with Family Business. It shows that we are learning to give and not always thinking about negotiating the best deal for ourselves. I have had a lot of heartburn for a long time, but one of the greatest things I learned from Bork is that life depends on how you frame it in your mind. If you truly believe that you get more from giving than receiving, it changes the way you view the world. Regardless of how much money I receive in compensation and distributions, the most important thing to me is that when you, my brothers, are working with me or playing golf with me or even just

when we are having a glass of wine together, that you are glad I am your brother and partner in business.”

One Pocket Practice - In Turkish families, it is not uncommon to have the practice of “One Pocket” when it comes to money. Family members spend out of the family accounts. In some ways, that was the way the father of the Stockton brothers was operating when he was “equalizing.” He just called the practice by a different name. What transpired is that the brothers, while working together, got accustomed to being unique, special and rewarded accordingly. They lost the mindset that “we are in this together” and began to compare themselves NOT with family members, but with their counterparts in other businesses. John has such high expectations that one has to wonder if he will ever be satisfied, even though he has more wealth than most of his age contemporaries. There was discussion of both Charlie and John moving their families to Texas – home of Zero personal income tax, but the Pacific Ocean is a long way away and their wives and children don’t want to leave the California sunshine.

The “One Pocket” practice in Turkey may soon be a thing of the past. There are families where some adult children live “the life” as if there is no limit to the resources. It seems to be approved by the elders but when the elders are gone, those brothers and sisters who are “living large” will likely have to deal with siblings who have different, and perhaps more conservative, views on how money is to be used. If Turkish business families are to avoid the Stockton heartburn, they must carefully examine the family monetary policy and what it is that holds their families together.