Tax Planning for Family Business Succession

Many owners of family businesses are so busy running their companies that they never get around to making formal arrangements to pass on the business to the next generation or to other partners. But a failure to prepare for having to hand over the reins of your company—especially in the case of an unexpected illness or death—can have serious financial consequences, and may even result in the forced sale of the business. While the question of who will take over your business is central to a succession plan, it is equally important to plan ahead for the tax implications of a transfer of business assets to your appointed successors.

The systematic gifting of shares of stock in the family business is one of the most tax-efficient approaches to transferring the value of a company to the next generation. Under current law, you are permitted to transfer shares worth up to $14,000 to an individual child or grandchild each year without incurring Federal gift taxes. For a married couple, the limit is $28,000. This process reduces the taxable value of your estate and minimizes any estate taxes that might be owed. However, any amounts above these limits that are transferred count against the estate tax threshold, which in 2014 is $5.34 million for an individual and $10.68 million for a couple. If you have a longer time frame to plan, you may be able to transfer a significant portion of your business to your family members through tax-free gifts, while retaining control of the company until you are ready to retire.

Another option is to arrange to sell your interest in the company to your heirs, either at retirement or in the event of disability or death. The standard set by the IRS for transfers of business interests between family members is the “bona fide business arrangement.” The sale of the company is not subject to transfer taxes provided the business is sold at full fair market value (FMV) and under the terms and conditions typically associated with arm’s length transactions. However, complications can arise if you lend your family members the cash needed to fund the transaction without charging market-rate interest on the loan, as the IRS may impose imputed interest income to both the holder and the issuer of the note. This can be avoided if your successors raise the capital through a bank loan, or agree to pay you the prevailing interest rates on the loan.

To facilitate the sale of the company and to allow you to keep control of the business until you are ready to retire, you may want to consider entering into a buy–sell agreement, a legal agreement that prearranges the sale of the business to a specified buyer, who may be a family member, a current owner or group of owners, or the business itself. When a specified triggering event occurs, such as your retirement or death, the buyer is obligated to purchase your interest at the FMV.

Another option is to use a private annuity to transfer ownership of the business to a family member in exchange for the promise of a lifetime income for yourself, and possibly your spouse. Provided the value of the annuity is in line with the value of the business interest that is being transferred, the transfer is classified as a sale and the value of the business will not be included in your gross estate for tax purposes. You may also want to consider a type of private annuity, known as the self-cancelling installment note (SCIN), through which the business is sold in exchange for an installment note that provides you with a set number of payments over a specified period of time and at a set interest rate. If you die before the note is paid in full, the note is cancelled, and no estate tax is due on the remaining balance.

Yet another vehicle for transferring assets while minimizing gift or estate taxation is the grantor trust. Under the terms of a grantor trust, the individual who creates the trust, or the grantor, transfers his or her assets to the trust in exchange for an income for a specified period of time. Types of grantor trusts include the grantor retained annuity trust (GRAT), an irrevocable trust that enables you to make gifts and transfer the FMV of assets on a discounted basis to family members, while receiving fixed annuity payments. Other types of grantor trusts are charitable lead trusts and the grantor retained unitrust (GRUT), which is similar to a GRAT, but has variable rather than fixed annuity payments.

If your goal is to transfer business assets while maintaining control over the business, you may want to consider establishing a family limited partnership. After setting up a limited partnership to hold the business assets, you can transfer some of the limited partnership units to your successors, thereby removing the units from your taxable estate. Because limited partnership interests do not come with control of the partnership, the value of the transferred assets may be discounted for the purposes of gift taxes.

If your business is operated as a corporation, you have additional options for passing on business assets to family members. A method sometimes used by corporations for transferring ownership while minimizing taxes is recapitalization, or the issuance of two classes of corporate stock, voting and nonvoting. The family members who are active in the business are awarded voting stock, while the nonvoting stock is used to provide equity to the inactive family members. Given the complexity of these and other strategies for business asset transfer and estate planning, you should seek advice from legal and financial professionals to determine which methods are right for you.

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