Business Exit Strategies: Transfers to Family

Overview

There are several ways to keep your business in the family. The method you choose will depend on whether you wish to keep ownership and control of the business until your death or begin transferring ownership (and possibly control) to your family during your lifetime. In addition, your options can be affected by the business entity itself. A sole proprietorship, for example, may have different options than a partnership or a corporation. The presence of a buy-sell agreement or another agreement between current owners may also impact your options. Choices for family transfers can also be affected by your overall estate planning goals. Insight, planning, and open discussion can contribute to the successful transfer and continuation of the family business.

One possible downside to conducting business transactions with family members is that the Internal Revenue Service (IRS) may more closely examine such transactions. There is potential for the IRS to question the price or valuation method used. As long as the transfer of your business can be shown to be for fair market value (FMV), the valuation is likely to be upheld. It is advised to consult professional financial, tax, and legal advisors, as well as a qualified business appraiser. By anticipating the worst when you structure a sale to a family member, you can avoid unpleasant surprises later, such as a gift tax assessment by the IRS if your valuation is contested or the inclusion of the business in your estate when you thought you had transferred it out.

The Decision to Retain or Transfer Your Business

If your heirs purchase the business from you, their tax basis will be equal to the purchase price. If you gift the business to them during your lifetime, your heirs' tax basis will be equal to your tax basis. The carryover basis is often very low, which can result in a significant income tax burden to your heirs if they ultimately sell the business and have to recognize gain equal to the difference between the sale price and the basis. Retaining ownership in your estate may result in increased estate taxes; however, it will also result in the tax basis adjusting to the value of your date of death or the alternative valuation date if elected. Given the current tax landscape, the benefit to your heirs of the basis step-up may exceed that of planning to avoid estate taxes. The overall tax impact should be carefully considered when deciding to retain or transfer your business.

Lifetime Gifts

Annual Exclusion Gifts

If you are prepared to begin transferring some of your business interests to your beneficiaries, a systematic gifting program can help accomplish this while minimizing the gift tax liability that might otherwise be incurred. In 2023, you can give up to $17,000 per year, per recipient without incurring gift tax or using any portion of your basic exclusion amount ($12.92 million in 2023, which may be transferred during your lifetime or at death without incurring gift or estate tax. This exclusion is scheduled to decrease after 2025 by reverting back to prior law with a $7.54 million estimated exclusion for 2026). If you are married, you and your spouse can make gifts up to double the annual gift tax exclusion free from gift tax, as long as you are both U.S. citizens and make the gifts jointly. By transferring portions of your business in this manner, over time you may manage to transfer a significant portion of your business free from gift tax. This strategy can provide you with the opportunity to ease your successor into the business and retain control by granting smaller ownership portions up until the time that you are ready to fully remove yourself from the business. The disadvantages of relying solely on this method of transferring your business are the amount of time necessary to complete the transfer of your entire estate and the need to annually determine the business value.

Family Limited Partnerships

Annual exclusion gifts may be used in conjunction with a Family Limited Partnership (FLP). With an FLP, you establish a partnership with both general and limited partnership interests. Then, you transfer the business to this partnership. You retain the general partnership interest for yourself, allowing you to maintain control over the day-to-day operation of the business. Over time, you gift the limited partnership interest to family members. The value of the gifts may be eligible for valuation discounts as a minority interest and for lack of marketability. If so, you may successfully transfer much of your business to your heirs at significant transfer tax savings.

Grantor Retained Annuity Trusts or Unitrusts (GRATs or GRUTs)

A more sophisticated business succession tool is a GRAT or GRUT. GRAT/GRUTs are irrevocable trusts to which you transfer appreciating assets while retaining an annuity or unitrust payment for a set period of time. In general, an annuity means you receive fixed periodic payments, while a unitrust means you receive payments of a fixed percentage of trust assets (revalued annually). At either the end of the payment period or your death, the assets in the trust pass to the other trust beneficiaries (the remainder beneficiaries). The value of the retained annuity or unitrust interest is subtracted from the value of the business interest transferred to the trust, so if you live beyond the specified payment period, the business may be ultimately transferred to the next generation at a reduced value for estate tax or gift tax purposes.

Sales to Family Members

When you sell your business interests, you receive cash that can be used to maintain your lifestyle or help to pay your estate taxes. You choose when to sell – now, at your retirement, at your death, or anytime in between. As long as the sale is for the full FMV of the business, it is not likely subject to gift tax or estate tax. If the sale occurs before your death, it may be subject to capital gains tax.

You may want to consider using a buy-sell agreement if you are planning to sell your business to a family member. A buy-sell agreement lets you keep control of your interest until the occurrence of an event that the agreement specifies, such as your retirement, disability, or death. Other events like divorce can also be included as triggering events under a buy-sell agreement. When the triggering event occurs, the buyer is obligated to buy your interest from you or your estate at the FMV. Price and sale terms are prearranged per the terms of the agreement, which eliminates the need for a fire sale if you become ill or when you die. Once executed, you are bound under a buy-sell agreement, although the agreement may be terminated by mutual agreement of the parties. You cannot sell or give your business to anyone except the buyer named in the agreement without that named buyer's consent. This could restrict your ability to reduce the size of your estate through lifetime gifts of your business interest, unless you carefully coordinate your estate planning goals with the terms of your buy-sell agreement.

Financing Considerations

If you sell your business to a family member, there are financing methods available that you may not consider when selling to a third party. These methods can be especially valuable when the family member buying your business does not have sufficient cash or borrowing capacity to make the purchase outright.

Private Annuities

A private annuity is the sale of property in exchange for a promise to make payments to you for the rest of your life. A private annuity differs from a commercial annuity because the buyer purchases the annuity from a private party instead of a financial organization (ex., an insurance company). With this strategy, you transfer complete ownership of the business to the buyer. The buyer in turn makes an unsecured promise to make periodic payments to you for the rest of your life (a single life annuity) or for your life and the life of a second person (a joint and survivor annuity). A joint and survivor annuity provides payments until the death of the last survivor. Since a private annuity is a sale and not a gift, it allows you to remove assets from your estate without incurring gift tax or estate tax. Until recently, exchanging property for an unsecured private annuity allowed you to spread out any capital gain realized, deferring capital gains tax. However, this tax benefit has generally been eliminated. If you are considering a private annuity, be sure to talk to a tax professional.

Installment Sales & Intentionally Defective Grantor Trust (IDGTs)

An installment sale might be a suitable financing arrangement when you are willing to accept payments over time, desire the additional security of a promissory note, and want to be sure you (or your estate) receive the full purchase price for your business. Unlike the private annuity, the buyer using installment payments must continue making payments to you or your estate until the full purchase price is paid. Any outstanding balance for the note securing the sale still due at your death must be included in the value of your estate for estate tax purposes. If you meet all requirements, you can spread your gain on the sale over the installment payment period.

The installment sale technique could be coupled with a sale to an Intentionally Defective Grantor Trust (IDGT). An IDGT is set up as an irrevocable trust that is rendered "defective" due to the intentional retention of an interest that violates the grantor trust income tax rules. As a grantor trust, income from the trust is taxed to you as the grantor rather than to the trust itself. In advance of a sale of assets to the IDGT, you should make an initial “seed” gift to the trust. This will allow the note used in the subsequent sale to be considered bona fide debt by making sure that the trust’s debt-to-equity ratio is not too high. Most practitioners recommend a gift equal to 10% of the value of the assets that will be sold to the trust and that the assets used for the seed gift should consist of cash or marketable securities to avoid valuation questions. If the IDGT sale is large or you have used up most of your applicable exclusion amount, you may have to pay gift tax when the trust is seeded. Following the seed gift, you would sell assets to the IDGT in exchange for a note. Valuation discounts, such as lack or marketability or minority discounts, may be available to reduce the value of the assets sold to the trust. Since the trust is considered a grantor trust, the sale is disregarded for income tax purposes and occurs without causing you to recognize capital gain. Similarly, the interest paid to you from the trust per the terms of the note will not be taxed to you.

Self-Canceling Installment Notes (SCINS)

A self-canceling installment note (SCIN) is a special form of installment note that is a hybrid of the private annuity and installment sale. It is sometimes referred to as a death-terminating installment sale. Like a private annuity, the payments end at death, and like an installment sale, the obligation can be secured with a note or collateral without jeopardizing the tax treatment. SCINs are sophisticated tools with major gift and estate tax consequences. Consult an attorney or tax advisor before establishing this financing method.

Deferred Compensation

In many family transactions, the tax cost of buying the business is often so high that it becomes unaffordable for the younger generation to buyout the senior generation even if the senior generation is willing to accept installment payments. Payments made under an installment note are not tax deductible by the buyer or the business itself. For example, if we assume a $1 million purchase price and a buyer with a combined 40% tax bracket, the buyer would have to earn $1,666,667 to be left with the $1,000,000 after tax to pay for the business interests.

To ease this burden, you may consider using deferred compensation as part of the transaction. The buyer (through the business) would be using pre-tax dollars instead of after tax dollars, lowering the overall purchase price. The problem with deferred compensation is that the seller will pay ordinary income taxes on the payments received. This is usually overcome by having the buyer increase the amount that is in the deferred compensation agreement to equalize the after tax effect to the seller.