Business Exit Strategies: Family Transfers

Keeping your business in the family can be a rewarding yet complex process. The exit strategy you choose will depend on whether you want to maintain control of the business until your death or begin transferring ownership during your lifetime. The structure of the business, such as whether it is a sole proprietorship, partnership, or corporation, will also affect your options. Additionally, estate planning goals and any existing agreements between owners, such as buy-sell agreements, play a role in determining the best course of action. Careful planning and open communication are key to help ensure the successful transfer and continuation of the family business.

IRS Considerations for Family Transactions

One challenge of conducting business transactions with family members is heightened scrutiny from the Internal Revenue Service (IRS). The IRS may closely examine the valuation of the business and question the price used in the transfer. To prevent complications like a gift tax assessment or the inclusion of the business in your estate, it's essential to ensure the transaction is conducted at fair market value (FMV). Seeking advice from financial, tax, and legal professionals, as well as obtaining a business appraisal, is crucial for avoiding surprises and securing the transfer.

The Decision to Retain or Transfer the Business

If you sell your business to family members, their tax basis will be the purchase price. However, if you gift the business during your lifetime, the heirs will inherit your tax basis, which could result in a significant tax burden if they sell the business later. Retaining ownership until death may increase estate taxes but will allow for a step-up in the tax basis, which could provide substantial tax savings for your heirs. It's important to weigh the overall tax impact when deciding whether to retain or transfer your business.

Lifetime Gifts

- **Annual Exclusion Gifts:** If you're ready to start transferring ownership, a systematic gifting program can help reduce gift tax liability. In 2024, you can give up to $18,000 per year, per recipient, without triggering gift taxes or reducing your lifetime exclusion amount ($13.61 million in 2024). For married couples, this exclusion can double. This strategy allows you to transfer portions of your business gradually, retaining control while easing the transition to your successors. However, this approach can be time-consuming and requires annual business valuations.

- **Family Limited Partnerships (FLP):** Family Limited Partnerships allow you to maintain control over the business while transferring ownership gradually to family members. By gifting limited partnership interests, you may qualify for valuation discounts due to lack of control and marketability, which can result in significant transfer tax savings.

- **Grantor Retained Annuity Trusts or Unitrusts (GRATs/GRUTs):** A more advanced strategy, GRATs and GRUTs involve transferring appreciating assets into an irrevocable trust while retaining an annuity or unitrust payment. After the payment period, the remaining assets in the trust pass to your heirs, often at a reduced estate or gift tax value.

IRS Considerations for Family Transactions

Selling your business to family members provides liquidity for retirement or estate tax planning. A sale conducted at FMV avoids gift and estate taxes, though it may trigger capital gains taxes if completed during your lifetime. Using a buy-sell agreement can help structure the sale, allowing you to retain control until specific events, such as retirement or death, occur.

Financing Options for Family Sales

- **Private Annuities:** A private annuity involves selling your business in exchange for periodic payments for the remainder of your life. While this method removes the business from your estate, recent tax changes have reduced the benefits of deferring capital gains taxes.

- **Installment Sales & Intentionally Defective Grantor Trusts (IDGTs):** In an installment sale, you sell the business over time, securing payments with a promissory note. This can be combined with an IDGT, allowing you to sell assets to a trust in exchange for a note, avoiding capital gains recognition and estate taxes.

- **Self-Canceling Installment Notes (SCINs):** SCINs blend features of private annuities and installment sales. Payments cease at your death, and the sale can be secured with a note or collateral. However, SCINs involve complex tax considerations and should be established with professional advice.

- **Deferred Compensation:** Deferred compensation agreements can help overcome the tax burden associated with buying out senior family members. While payments to the seller are taxable as ordinary income, this structure may lower the overall purchase cost for the buyer by using pre-tax dollars.

Conclusion

Successfully transferring your business to family members requires a well-planned strategy that balances tax considerations, liquidity needs, and control. By understanding the available options and seeking professional advice, you can help ensure a smooth transition that aligns with your family's long-term goals.

Important Disclosure: The information contained in this whitepaper is intended to be general in nature and for informational purposes only. It should not be considered as investment advice or as a recommendation of any particular tax or investment strategy or product. Moreover, this whitepaper is not a solicitation or an offer to provide any specific tax, estate planning or financial planning service. Please consult with qualified tax, legal and/or financial professionals for advice specific to your situation before engaging in any business succession strategies.