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ROADMAP TO WEALTH TRANSFER FOR A FAMILY BUSINESS

Planning in advance is key and can help increase the likelihood of a successful transition. There are several ways to accomplish this.

Gifting to a Family Member:

1.Transfer Through Your Estate – Through a Will and Trust, there will be language whereby the family member(s) will receive ownership of the business upon the owner's death. The only downside to this is the transfer will happen sometime in the future. One of the key benefits is the inheritor will receive a step up in basis to the FMV at time of the owner's death. If and when they sell the business, there will be fewer capital gains tax because of this stepped-up basis.

2. Gifting Over Time – Through the use of the annual gift tax exclusion which is $18,000 per person can be gifted without having to report the transaction to the IRS. If a married couple both own shares in the business, each can give $18,000 or $36,000 jointly to a single person. It is important to understand that gift tax is paid by the giver not the receiver. This is beneficial to the giver if they have a substantial taxable estate because this will lower their assets in the estate that would be subject to tax. This is beneficial to the recipient because they will be receiving ownership currently and will increase over time.

3. Gifting All At Once – An immediate one-time gift can be done during the owner's lifetime and the owner's lifetime gift tax exclusion can be used to shield gift tax. The lifetime gift tax exclusion is $13.61million (in 2024). If a married couple owns the business jointly, this amount doubles to $27.22 million in lifetime gifts. The amount of this large exclusion is set to expire in the tax code in 2025. Experts are predicting this amount will be cut in half. If the value of the business is greater than the annual exclusion, this will prompt the giver to prepare a 709 Gift (and Generation-Skipping Transfer) Tax Return.

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Qualified Appraisal –a qualified valuation will need to be performed when gifting shares to support the fair market value (FMV) of the gift. The Valuation, if done accurately the appraiser should be certified such as Accredited in Business Valuation (ABV), Certified Business Appraiser (CBA), or Certified Valuation Analyst (CVA). In addition, the IRS revenue ruling 59-60 outlines several factors that business appraisers must consider when determining the FMV of closely held stock.

Sell to a Family Member:

These gifting strategies will not provide value to the owner gifting the business. If the owner needs value to fund their retirement, a sale structure will be a better approach. The child buyer may not have the liquidity to buy it or the credit to get an outside loan to fund the purchase. Therefore, a Seller Note will be the way to go. Some key points on a private transaction sale with a seller note are:

1. There are no restrictions or requirements to sell at FMV – you can set the price that suits both parties.

2. The seller's note will provide a stream of income for retirement. There is a risk if the business fails.

3. A loan must have a minimum amount of interest charged or the IRS will create imputed interest. The minimum rate is equal to the Applicable Federal Rate (AFR), which is typically well below the Prime Rate.

4. Interest income will need to be reported by the Seller.

Using a Trust to Transfer a Business:

There are several trust vehicles that can be used as a combination or stand-alone method of transferring business interest to family members. Most of these are for the benefit of the grantor's estate and all of them have different tax and estate saving features. In addition to needing an estate planning professional, a lawyer will create the trust and handle the legal work of transferring the business. The most commonly used trusts used to transfer businesses are:

1. Living Trust – is a trust that springs into action upon your death where you set up what assets will go into the trust and then be distributed to your beneficiaries upon your passing. This helps avoid contested will and probate court.

2. **Intentionally Defective Grantor Trust (IDGT) –** this is a type of irrevocable trust that allows the grantor to remove assets from their estate while retaining ownership for income tax purposes. Typically, a portion of the business is gifted and the other portion sold to the trust. A seller's note is put in place where the proceeds from the note will cover the grantor's income tax liability.

3. **Grantor Retained Annuity Trust (GRAT) –** is a type of irrevocable trust that allows a grantor to transfer assets while still receiving income from the business in the form of an annuity, generally from 2 to 10 years. After the GRAT's term expires, the assets (your business) remaining in the trust transfers to designated beneficiaries.

Choosing the right trust and the provisions of the trust should be carefully crafted with a professional who understands the legal, estate & gift tax and income tax rules for each type of trust. For example, to avoid tax on gifts that are in excess of the annual exclusion limit should have what is called "a Crummey" provision in it. This makes the gift considered to be a present interest (as opposed to a future interest) and eligible for the gift tax exclusion. This provision allows the beneficiary to withdraw from the trust immediately for 30 to 60 days, but they do not exercise the right to do it.