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Strategies to Consider Now For A Tax-Efficient Business Exit Later

If you own a thriving business, sooner or later you're likely to sell it, gift it to family members or take it public. Whether you're just starting out or thinking about retiring in the next few years, it's not too soon to consider your strategy for managing change to your greatest financial asset.

A key part of that planning includes considering what steps you'll take to mitigate tax burdens for yourself and your successor.

The day you open your business is the day you have to plan for exiting it.

In fact, the later you start planning, the worse your chances of minimizing the tax hit when your business eventually changes hands. Even if you expect to hold onto your company for the foreseeable future, the business represents value within your estate that needs to be properly handled, he noted.

It's also wise to prepare for the unexpected — perhaps even an out-of-the-blue offer far exceeding the valuation you'd estimated for your enterprise.

OPTIONS FOR ASSET PROTECTION AND TAX SAVINGS

Start by consulting with your financial advisor, lawyer and accountant, each of whom can help you evaluate your estate and plot the most financially sound moves.

Be sure to understand your company's governing documents, as they may limit what you can do to structure the business to best benefit owners and successors in a transaction. You can change these documents anytime, so ask your advisors to review them and make suggested improvements.

Any business faces a number of potential exit scenarios. Owners might sell or give the company to the family's next generation — or transfer the business through a sale-gift combination — or sell to employees or an outside third party.

Redemption of shares to a partner presents another possibility.

In typical third-party sales, strategy should focus on asset protection and tax savings, with the planning ideally occurring long before a transaction. That's because once a potential offer is on the table, options become more limited.

THE GRAT OPTION

One popular tool is a grantor retained annuity trust, or GRAT. It provides a vehicle into which an owner can move an ownership interest in a business, taking it out of their estate. This enables beneficiaries to eventually take possession of the business when the trust expires, while saving significantly on estate taxes.

An owner can place the company in a GRAT at a relatively low valuation, with growth occurring outside his or her personal estate.

But if you wait until someone makes an offer on your business, it's too late to benefit from transferring shares to a GRAT. This is because you can't value an asset at less than its known worth.

For instance, an individual who planned to eventually sell a family business obtained a valuation of roughly $10 million and placed his company shares into a GRAT. His brother and co-owner did the same. The following year, they received an offer to sell the business for $65 million.

After the sale, because of the GRAT, they each have an annuity for a period of years from the returns on the liquidity event from the sale. But ultimately they saved millions in estate tax by passing the lower value shares into the GRAT during their lifetimes — prior to receiving a letter of intent to buy the business — rather than upon their passing.

Owners also can use a GRAT for a business they might take public, allowing families to pass along assets quickly while avoiding paying estate taxes on soaring post-IPO share prices.

But because there are various reasons why someone may or may not use the GRAT strategy, it's always important to consult with an attorney and a CPA for a comprehensive analysis of your unique situation. One of the risks: If the business owner dies before the GRAT expires, all assets in the GRAT return to the estate, and the business owner's heirs will have to pay taxes on the full value of the business.

GIFT-TAX EXCLUSION

To transfer ownership of a closely held business to the next generation, you also can use the annual gift-tax exclusion as a powerful tax-saving technique. As with other assets, an individual may give anyone cash or other assets valued up to the annual gift-tax exclusion — $15,000 in 2021, or $30,000 for a gift from a married couple — tax free.

One couple used this strategy to pass ownership interest in their business to their children, starting in 2017, when the limits allowed them to jointly give the equivalent of $28,000 per child. (The exclusion amount is reviewed and adjusted for inflation each year.)

Since one of their four children won't be participating in the family business, the parents decided to make annual gifts of equal value to that offspring.

But if you plan to transfer a business to children by giving shares over time, it's important to obtain and cement a valuation at the outset. The IRS allows closely held businesses to discount the value of shares for a valid purpose, such as minority share discounts or closely-held business discounts.

Those can help families transfer valuable assets while taking greater advantage of the annual gift-tax exclusion.

FAMILY LIMITED PARTNERSHIP

A family limited partnership, or a FLP, is another option that allows significant estate- and gift-tax savings when business ownership passes between family members.

In this scenario, an owner and spouse, for example, transfer assets to a newly created limited partnership in exchange for a 1 percent general partnership interest and a 99 percent limited partnership interest — a move that lets them stay in charge while shifting assets to others.

The couple maintains complete control over the partnership through their general partnership interest, even though it represents only a small percentage of the family limited partnership's value.

They can donate limited partnership interests to family members all at once or over many years.

The value of these limited partnership interests will be significantly discounted due to the partnership's lack of operational control — third parties would pay less for a restricted interest in a company than they would for unrestricted control — which works to the family's financial advantage. The discounted value allows the business owner and spouse to give much more property to their heirs on an annual tax-free basis.

Eventually, as the couple ages or decides to give up control of the FLP assets, they may choose to transfer general partnership interests to heirs. This would help ensure that, when they die, the IRS doesn't determine they retained too much control and shift the partnership's full value to the estate, hitting their heirs with a big tax bill.

BEFORE ACCEPTING AN OFFER

Business owners sometimes find themselves presented with an unexpected offer that sounds too good to refuse. In this case, we urge them to carefully evaluate the tax and long-term implications before they accept.

Consider, for instance, a business worth $10 million that earns $1 million a year, with the owner perhaps taking home $500,000 annually. Along comes an eye-popping offer to sell for $30 million, which might net the owner $15 million.

Will that $15 million generate $1 million a year? Will it support the owner's family for the next 20 or 30 years?

People might be wowed by a large offer but may be better off keeping the business, working for a few more years and generating additional value in the company prior to a future sale.

Owners often do sell in these situations, without having prepared in advance. In one instance, though, a client with a tech business held off, feeling the company was in a position to increase in value significantly in five years.

So with that we did do some planning. The client restructured from a C corporation to a S corporation, transferred funds into an investment portfolio and placed the business in a GRAT. The client is now positioning the company for sale, possibly in a few years.

Given the complexity and the number of options available, it's important to consult with professionals to evaluate your situation before a sale.

To learn more contact your Financial Advisor or CNR Senior Investment Consultant or Portfolio Manager.

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