Protective

BUSINESS CONCEPTS

Transferring a Growing Business to Future Generations

The Concept

- Estates are highly taxed. In 2024, the top federal estate tax rate is 40% and the applicable exclusion amount is $13,610,000.
- Family business owners can reduce potential estate tax liability by transferring ownership to younger family members who want to manage and grow the business.

Technique: Lifetime Gifts

- Business owners can use lifetime gifts to transfer a business interest. To reduce the federal gift tax, owners can take advantage of the federal gift tax exemption, gift tax annual exclusion, gift splitting between spouses and the gift tax marital deduction.
- The **federal gift tax exemption** allows an individual to make taxable lifetime gifts and taxable estate transfers up to the exemption amount ($13.61 million in 2024) without incurring tax. This means a business owner can make a partial or complete transfer of the business to the next generation sheltered from gift taxes.
- The **gift tax annual exclusion** lets an individual give up to a certain amount per year ($18,000 in 2024) to an unlimited number of individuals free of federal gift tax. It must be a gift of a present interest to qualify.
- **Gift splitting** allows married couples to treat gifts made from the separate property of one spouse as if each spouse gave half of the gift. This effectively doubles the gift tax annual exclusion amount (to $36,000 in 2024).
- The **unlimited marital deduction** allows a business owner to transfer a business interest to a spouse completely sheltered from the gift tax. This marital transfer shifts some or all business growth to the spouse's separate estate.

Technique: Private Annuities

- A business owner can sell a business interest to family members in exchange for a private annuity or an installment promissory note. This technique shifts future appreciation of the business to the buyer and assures the seller of a future stream of income.

- This technique also spreads the seller's income tax over the payment period. Under regulations issued by the IRS in 2006, the seller must recognize any capital gain on the transfer of property in the year of the transfer.

Technique: Changes in Business Form

- Changing the form of a business (e.g., to a family limited partnership or limited liability company) or restructuring the capital of a closely held business (corporate recapitalization) can freeze the value of an older family member's business interest at its current level.
- Business owners may use such changes to reduce the estate tax value of a business interest while shifting the business's future growth in value to the younger generation.
- A business owner must engage professional help to navigate special IRS valuation rules designed to regulate estate-freezing techniques.

Technique: Equalizing Inheritances

- Often, a business owner will have children who are actively involved in the day-to-day operation of the family business and other children who are not involved in the business. Because the business is likely to make up the majority of the estate, if the owner bequeaths the business to those who are active participants, there may be a need to equalize the inheritances for those working outside the business (assuming remaining estate assets are insufficient to provide this balance).
- Life insurance provides a solution. The owner can purchase insurance on his or her life and name non-participating family members as beneficiaries. The face amount should represent the amount needed to equalize inheritances.
- The business owner may also encourage non-participating children to purchase the policies themselves, then make gifts equal to the annual premiums using the gift tax annual exclusion.
- Inheritances may not be identical, but will be equitable, which preserves family harmony. Children active in the business are freed from the burden of having to buy out inactive family members when the business can least afford it. Children outside the business receive cash instead of a business asset they need to sell.

The Bottom Line

Shifting business interests to younger family members can have the dual benefit of saving estate taxes while assuring the younger generation that their involvement in the business will continue into the future.

SUMMARY

A family business may comprise a sizable asset—often large enough to expose the estate to the federal estate tax. In 2024, the applicable exclusion amount is $13,610,000 and the top federal estate tax rate is 40%. Because this tax can be difficult or even devastating for the heirs and the business, owners of family businesses often seek to reduce potential estate tax liability by shifting the business's future growth to younger-generation family members.

Techniques for Transferring a Growing Business

The various techniques for shifting future business growth to future generations can be grouped under three general categories:

- A **lifetime gift of a business interest** to family members to take advantage of gift tax exclusions and deductions, effectively reducing the size of the business owner's estate.
- The **sale of a business interest** to family members in exchange for a private annuity or installment note.
- A **change of business form** to freeze the value of an older family member's business interest at its current level.

Lifetime Gifts

With a unified exemption amount of $13.61 million in 2024, a business owner can pass along partial or even complete ownership of the business to children free of gift taxes. The annual gift tax exclusion ($18,000 in 2024) limits the amount the business owner can give each individual recipient per year free of federal gift tax. To qualify for the exclusion, it must be a gift of a present interest.

A married business owner can elect to split the gift with a spouse, effectively doubling the amount that can pass free of the federal gift tax each year (to $36,000 in 2024). This strategy applies even if the gift is solely the property of one spouse.

A married business owner can also choose to shift some of the business growth to the spouse's separate estate. The unlimited marital deduction will shelter these marital transfers from the gift tax.

Private Annuities, Installment Sales

A business owner can shift future appreciation of the business to the younger generation by selling a business interest in exchange for a private annuity or installment. This assures the seller of a future stream of income and spreads the seller's income tax on the sale over the payment period. With respect to private annuities, regulations issued by the IRS in 2006 require the seller to recognize any capital gain on the transfer of property in the year of the transfer.

Changes in Business Form

Changing the structure of the business can freeze the estate-tax value of an older family member's business interest by shifting the business's future growth in value to younger family members. Techniques include changing the business to a family limited partnership or limited liability company, or undertaking a corporate recapitalization.

Equalizing Inheritances

Business owners face a dilemma in passing a business to multiple children if they are not all actively involved in day-to-day operations of the family business. Children who are not active in the business may not want the aggravation of selling their interest for needed cash, and children who are involved may struggle to come up with the cash to purchase their siblings' unwanted interests.

One solution is to bequeath the business to those children active in the business, then equalize inheritances for other children using life insurance (assuming the remaining estate assets do not equal the value of the business). The business owner can buy the policy and name inactive children as beneficiaries, or the children can buy the policies with the owner gifting them the annual premiums under the annual gift tax exclusion. Either way, the inheritances, while different, will be of equivalent value.

When considering any of these techniques for transferring business interests to reduce or eliminate estate taxes, it's a good idea to seek professional help in deciding which one works best in a given family situation. This is particularly true in considering a change in business form, which can run afoul of strict IRS valuation rules designed to regulate the use of estate-freezing techniques.

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