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Private Client Services

Estate Planning Issues to Consider Before Selling Your Business

The Bottom Line

- Business owners can minimize taxes and maximize proceeds on the sale of his or her business by utilizing different estate planning strategies.
- It is critical, though, that the estate planning be done well in advance of the sale of the business or even before the preparation of a term sheet related to the possible sale of the business.

Estate planning is often associated with individuals making end-of-life decisions about finances and how their assets should be transferred and maintained for the benefit of their family members. However, business owners should understand the important role estate planning can play when selling a business and how to maximize the overall benefits derived by the business owner and their family members. Careful estate planning is especially important now in view of the pending substantial reduction of the current lifetime estate and gift tax exemption.

There are options available to structure ownership holdings that maximize sales proceeds while minimizing estate and gift taxes. Business owners should discuss these tactics with both business and estate planning attorneys. These options include:

1. Lifetime gifts, in trust, through various types of grantor trusts for individual family members and/or other key people involved in the business;
2. Lifetime transfers to a Grantor Retained Annuity Trust (commonly referred to as a "GRAT");
3. Outright gifts to family members and/or key people involved in the business and
4. Charitable gifts to family foundations, donor advised funds, Charitable Remainder Unitrusts (CRUT) or public charities.

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The Lifetime Estate/Gift Tax Exemption is Increasing, But May be Drastically Reduced

In 2023, the federal lifetime estate and gift tax exemption is $12.92 million per person. The estate tax exemption is indexed for inflation each year but is scheduled to be reduced by 50% as of Jan. 1, 2026.

In addition, if a business owner is married, he or she may "split" any lifetime gifts, meaning that, in 2023, a married couple may transfer $25.84 million of assets without paying any federal gift tax. Also, every U.S. citizen may make annual exclusion gifts to an unlimited number of people, whether related or unrelated, in the amount of $17,000 per donee. This means that a married couple may gift $34,000 to each of their children and grandchildren (or anyone else) every calendar year with no gift tax consequences, and without using any portion of their lifetime estate and gift tax exemption, which would remain available to shield larger lifetime gifts. Or, if not used during his or her lifetime, the remainder would be available in his or her estate to avoid federal estate tax on amounts left to spouses who are not U.S. citizens, children or other non-charitable beneficiaries.

When a person dies, his or her assets are valued at their fair market value as of the date of death, or on the alternate valuation date, which is the date of sale, disposition or its value six months after the date of death if the total value of the estate declined, for estate tax purposes. Therefore, on assets gifted during an individual's lifetime, all future appreciation on those assets accrues outside of the person's estate and will benefit the recipient of those assets after those assets are transferred. For example, if the appraised value of a business is $30 million, but the business owner believes it will eventually sell for $90 million, the prudent business owner will employ estate planning techniques to ensure that the future appreciation of the business accrues outside his or her estate, while also minimizing the income taxes due from the owner upon any sale.

Utilizing a Grantor Retained Annuity Trust (GRAT)

By transferring ownership interests in a company to a GRAT, future appreciation accumulates in the GRAT and outside of the business owner's estate, while the original asset (or asset value) flows back to him or her. For example, continuing the scenario above, the business owner may transfer ownership of 25% of the business interests into the GRAT at the current valuation, ignoring the potential sale ($7.5 million). Assuming the GRAT is for two years, the business owner will receive two payments of approximately $3.75 million at the end of the first and second years. Simultaneously, during that time, if the business is sold, the GRAT will realize gross proceeds totaling $22.5 million. Thus, the owner transferred $15 million in value, while making a taxable gift totaling $527,250.

Moreover, since a GRAT is a grantor trust, the grantor business owner pays the income taxes from his or her personal funds, allowing the full $15 million in sales proceeds to accrue to the GRAT. As shown above, if done correctly, the GRAT will not use any significant portion of the business owner's estate and gift tax exemption and allow for the virtually estate tax-free transfer of $15 million..

Gifts to Family Members Outright or in Trust

Often business owners would like to gift shares of the business to their children and grandchildren. Using the example above, the business owner and his or her spouse may gift 25% of the business interests, or $7.5 million, to their children and grandchildren or trusts for their benefit.

However, since the 25% interest is a minority interest, an appraiser will value the transferred interest at less than $7.5 million, after applying IRS-approved discounts for lack of control and lack of marketability, which each may total 25% but are recently trending lower. Moreover, the discounts are not added together, but applied one after the other. Assuming a lack of marketability discount of 20% and a lack of control discount of 10%, the $7.5 million gift is valued for gift tax purposes at $5.4 million ($7.5 million x .8 = $6 million x .9 = $5.4 million). After, once the sale is complete, the transferees will have $22.5 million in value, less applicable income or capital gains taxes.

To further increase the value of the gift, prior to the sale, the business owner may gift the interests to a grantor trust, so that he or she may pay all applicable taxes for the remainder of his or her lifetime while the funds remain in trust.

Gifts to Charity

If a business owner would like to donate to a charity upon the sale of his or her business, then he or she has options to maximize the gift and minimize taxes. Available options include forming a private foundation or making a gift to a donor-advised fund or public charity. Under any of these options, the business owner may sell the company, pay all associated income taxes, then transfer cash to the charity and take an income tax deduction.

Another option is to transfer business interests to a CRUT, or directly to the charity, prior to the sale of the company and take the income tax deduction at the appraised value of the interests. Then, upon the sale of the business, the charity will receive the sales proceeds for the percentage interest it owns, at the increased valuation; however, no income taxes will be due because charities are not subject to income tax on gains, although the CRUT beneficiaries will pay income tax on any distributions they receive.

For More Information

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