

# H G & G U P D A T E

Hofheimer Gartlir & Gross, LLP

Fall 1999

## *The Tax Aspects of Business Succession Planning*

### **Did You Know?**

*More than 80% of Americans are employed in businesses that are closely-held or operated by one or more families.*

*Unfortunately, these closely-held and family businesses often do not survive beyond the second generation—the survival rate is less than 50%.*



*But I'd always kind of assumed that the one inevitability cancelled out the other.*

### **1 Why do these businesses fail?**

- Failure to properly plan for the succession of management.
- Failure to address the needs of key employees and how they will work together with members of the founder's family.
- Disharmony among family members—active vs. non-active members.
- Failure to properly plan for the effect of taxes.

### **2 When should I do my succession planning?**

Succession planning is a constant, ongoing process. It should be considered:

- At the formation of the business,
- While the business is growing, and
- When you approach retirement.

### **3 What are the areas that a succession plan must address?**

- Minimizing taxes
- Shifting control

- Shifting ownership
- Continuity of management

## **4 Suppose I want to transfer all or a portion of my business to my spouse or my children? What are the tax issues I should know about?**

If a transfer is without consideration—a gift or bequest—gift tax or estate tax (and possibly a generation-skipping transfer tax) may be imposed.

### **Gift Tax:**

This tax is imposed on gifts made during life.

The Federal gift tax starts at 37% (on cumulative lifetime taxable gifts over \$650,000) and increases to 55% (on taxable gifts over \$3,000,000).

The New York State gift tax starts at 5% (if cumulative lifetime taxable gifts are over \$300,000) and increases to 21% (on taxable gifts over \$10,100,000).

### **Exclusions and Credits (non-taxable gifts):**

#### ***Annual Exclusion.***

You can give away \$10,000 tax-free (\$20,000 for a married couple) each year to each of as many persons as you wish.

#### ***Federal Unified Credit Amount.***

You can use this credit to make lifetime tax-free gifts of up to \$650,000 (in addition to the \$10,000 per person per year). A married couple is allowed \$1,300,000 (\$650,000 each). This amount phases up to \$1,000,000 per person by the year 2006.

#### ***New York State Unified Credit Amount.***

You can use this credit to make lifetime tax-free gifts of up to \$300,000.

**The New York gift tax is repealed for gifts made after January 1, 2000.**

## **5 What if I want to give a portion of my business to my spouse?**

There is no gift tax for most gifts to your spouse, regardless of amount. Some gifts in trust qualify for tax-free treatment.

## **6 What if I sell my business to my children for \$1.00?**

A sale for less than fair market value will be treated as part sale-part gift, thus producing both an income tax and a gift tax.

### **Estate Tax:**

## **7 The Estate tax is unified with the gift tax.**

The estate tax rates are basically the same as those for the gift tax.

**Effective February 1, 2000, New York will reduce its estate tax to bring it in line with "retirement" states such as Florida and Arizona.**

The Unified Credit Amount gives you "one bite at the apple". Gifts during your lifetime that are sheltered by the Unified Credit Amount reduce the credit available at death. Tax-free gifts between spouses are generally unlimited (same as for gift taxes).

## **8 QFOBI Deduction.**

Federal estate tax law provides for a deduction for "qualified family-owned business interests"—which shelters up to \$1,300,000 from estate tax. This QFOBI deduction "wraps around" the Unified Credit Amount so that in 1999 it is really only \$650,000 (unified credit to cover \$650,000 + QFOBI deduction of \$650,000 = \$1,300,000 total). When the Unified Credit Amount

reaches \$1,000,000, the QFOBI deduction will be \$300,000.

Both spouses may be able to use the QFOBI deduction (protecting \$2,600,000 of the business).

**Generation Skipping Transfer Tax (“GST”):**

The GST tax is imposed on transfers that “skip” a living generation (such as gifts to grandchildren).

Rate: presently 55%. This tax applies in addition to the estate and gift taxes.

Lifetime (gift and estate) cumulative exemption: \$1,010,000 (adjusted annually for inflation). Married couples thus are allowed \$2,020,000.

**9 What are the tax advantages of making gifts of my business during life as opposed to leaving the business to my heirs at my death?**

**Gifts cost fewer tax dollars than bequests.**

Gifts of minority interests will be valued favorably for gift tax purposes.

The founder may be reduced to a minority position, which can produce a benefit for estate tax valuation purposes.

**10 What are the tax disadvantages of my making lifetime gifts rather than transfers by my Will?**

For income tax purposes, the recipient of the gift takes your “tax cost” of the business interest that was given (“carryover basis”). This will typically be lower than the value of that interest at your death.

**11 What are the tax advantages of a transfer at death?**

For income tax purposes, the beneficiary takes a “stepped-up basis” for the business interest (assuming its value is more than you paid for it), thus reducing the income tax on a later sale of the interest by the beneficiary. The QFOBI deduction for a family business is available only for estate tax, not gift tax.

**12 What are the tax consequences of transferring the business to my children or my employees other than by gift?**

***Spin-off.***

If your business has two or more divisions, and your children or employees are already part owners, it may be possible to accomplish the transfer on a tax-free basis via a spin-off.

***Installment Sale.***

An installment sale “freezes” the value of the business interest sold and defers the gain until the seller receives payments of the purchase price. If the selling price is at fair market value, there is no taxable gift (although there would be a gift if the seller were to cancel any portion of the installments). The seller’s estate includes the unpaid amount of the installment note.

***Self-Canceling Installment Note.***

The unpaid installments under this type of note will not be included in the seller’s estate, but the cancellation feature will increase the price the buyer has to pay. Any unpaid installments must still be reported for income tax purposes at the seller’s death.

***Private Annuity.***

In a private annuity, the buyer agrees to pay the seller a fixed number of dollars per year for the rest of the seller’s life. If structured

properly, neither the transferred property nor the annuity right as such will be included in the seller's estate.

### **Sale to ESOP.**

All or a portion of the business can be sold to an "Employee Stock Ownership Plan," which is a profit-sharing plan designed to own shares in the employer's business. The ESOP

offers the closely-held business owner the opportunity to reinvest the proceeds from the sale of his or her stock to the ESOP into higher-yielding investments or to make a charitable contribution of the proceeds without incurring capital gains tax. The employees, through their interest in the ESOP, own the interest in the business.

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This is the first in a series of articles on Business Succession Planning. If you have any questions or need further information, please contact Bob Howard, Mary DeMarco Abrams, or any of our other partners.

## ■ Litigation Update

HG&G successfully argued an appeal of a Supreme Court decision granting a million dollar judgment based on a group of notes and guarantees. The Appellate Court held that the debt was acknowledged in the debtor's financial statement, thus extending the statute of limitations.

We successfully settled a multi-million dollar action brought on behalf of a major retailer against a computer service provider for its failure to fully complete its obligation to render the retailer's mainframe based data bases Y2K compliant.

## ■ New Associates

We are pleased to announce that Erika L. Jenkins and Kristina Z. Kiesel have become associates in our firm.

### About Hofheimer Gartlir & Gross, LLP

*The firm conducts a general commercial practice. Our principal practice areas are:*

- real estate
- corporate and securities law
- general business and commercial law
- cooperative and condominium matters
- financial institutions (loan transactions, leasing, acquisitions, credit restructuring, workouts and foreclosures)
- estate planning
- trust and estate administration
- general litigation
- matrimonial and family law
- taxation

*Clients of the firm range from major financial institutions and public corporations to closely-held businesses, individuals and families.*