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ACCOUNTING

Passing down your family business

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It's a shocking but common statistic for business owners who retire: More than half the sale price of your business could be lost to the IRS when you sell it or pass it down. The scenario can play out in various ways depending on how your business is structured. A retiring C Corp owner, for example, might sell his $1 million of stock in his business and realize too late that his long-term capital gains tax is a staggering $240,000. And then there's the buyer's tax bill. Depending on the buyer's income tax bracket, an added $690,600 might be needed to walk away with that same $1 million in stock. Consider now that this is a family business. All combined, the sale of that $1 million in stock — just to pass it from one generation to the next — costs the business owner and his heir $895,600 in taxes (a "tax rate" of 55 percent).

Whether your end-goal is family succession, selling the business, or dissolving it when you retire, start strategizing now and be prepared to change course when needed. The process is called exit planning or succession planning, and it can help you and those who inherit your business after you, avoid an unnecessarily huge tax bill.

Three in five small businesses do not have an exit plan in place. In nearly half of those businesses, the business owners simply believe it's not necessary. The truth is, with 100% certainty, you WILL leave your business. You may retire, quit, close the company, sell the business, or work until they carry you out. No one is an exception to the rule. So if you want to leave a strong legacy behind, it's time to start planning ahead. We often recommend starting 10 years in advance because it takes that much time to alter your course from "build mode" to "exit mode."

Often when business owners put together an exit plan, they realize their business structure should change. That's because a corporate entity like a C Corp is financially much different from a pass-through entity like an LLC, S Corp or partnership. The business structure that's been right for you for years may not be right for a transition because it can affect your business operations (liability, credit, tax treatment, etc.) Changing tax laws like those concerning bonus depreciation and estate taxes can affect business structure for exiting owners, too.

One of the biggest traps owners fall into when selling their business is with balancing capital gains versus ordinary income. Ordinary income is taxed at a higher rate than capital gains but sometimes paying more in ordinary income taxes produces better results. With careful coordination, taking a bigger tax hit can often be reimbursed by the buyer, for a lower overall cost.

An exit plan can help you gain tax advantages in these areas by helping you rethink and recharacterize certain assets in your company. Even a self-created asset like personal goodwill (which includes your reputation, expertise, skill, knowledge and the relationships you've built) can now be sold, along with or separate from the business, but this is also taxed. Add these factors to dozens of other considerations when it comes to tax-proofing the legacy of your business, and you can see how critical exit planning can be. Even your Social Security and retirement benefits can be affected. You'll leave your business at some point, and the IRS is betting on it being on their terms, not yours. Give yourself some time to prove Uncle Sam wrong.

Steven Bankler has more than 40 years of experience in the accounting industry. Steven's expertise lies in consulting, planning, tax, and asset protection as well as exit strategy services for closely held businesses. He also provides litigation support (both as a testifying expert witness and a consulting expert), business negotiations and estate planning.

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