PUBLICATION

Business Succession Planning in the Current Tax Environment

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Business succession planning in the current tax environment may require an adjustment in thinking from traditional planning. Traditional planning usually attempts to transfer ownership of the business to the next owner (often children) as early as possible to avoid significant entity value being included in the owner's estate for federal estate tax purposes. This type of planning was driven by a low estate tax exemption, high estate and gift tax rates and a low federal capital gains tax rate. The current tax environment may reverse this in certain circumstances.

The current tax environment has a higher estate tax exemption, lower estate and gift tax rates, stepped-up basis for income tax purposes for inherited property (the same rules as previously existed) and a higher federal capital gains tax rate. A married couple is allowed an estate tax exemption equal to $10,860,000 in 2015. The exemption, indexed for inflation, is projected to grow to $13,160,000 by 2024 – in less than nine years! On the other hand, the highest marginal federal capital gains tax rate is now 23.8 percent. This means that business succession planning for businesses under these larger exemptions, may be turned on its head.

For example, imagine Dad and Mom own a business they grew over the years, which is now worth $10,000,000. If they retain ownership of the business for their joint lifetimes, the business will pass tax-free to their children. Even better, the children will take a basis, for income tax purposes, in the business equal to its fair market value at the time of each death, even if that value is much larger than the investments of capital made by Dad and Mom, without any capital gains tax. That means, in addition to no estate or gift tax on the inheritance of the business, there also is no capital gains tax on the first $10,000,000 of value received in the event the children sell the business. Even better, if the business is a limited liability company or a partnership (in both cases, taxed as a partnership for federal income tax purposes), when the children inherit the business, the business is permitted to "mark to market" all of the assets of the business (and if there are not enough identifiable assets to "mark to market", to record goodwill for tax purposes). If the children wish to retain and operate the business, this means additional depreciation and amortization deductions for the business which will reduce the business's taxable income and the income tax liabilities of the children.

Traditional planning for business succession – often, sales or gifts of ownership interests to children (or grandchildren) – may not be tax efficient given the tax environment we now find ourselves in. Planning now requires thoughtful preparation to achieve tax minimization.

For more information about how business succession planning may affect your business, or related matters, contact the author of this alert, Ross N. Cohen, or any members of the Firm's Tax Group.