

## Keeping It in the Family: Transferring Your Company to a Business-Active Child



*You may have decided that your best exit path is to successfully transfer your company to a business-active child. As is the case with any exit path scenario, the first step in choosing an appropriate exit technique is identifying your ownership transition objectives. After you have set your exit objectives, the next step is to align your objectives with the most advantageous exit path.*

### Case Study

Ted, 69, owns an S corporation, producing cash flow of \$1 million annually, and valued at \$5 million. He wants to transfer 20% of his company to his business-active child, Sharon, as soon as possible. He's not looking for immediate cash from this initial transfer of company, so he can choose to sell ownership, gift ownership, or transfer ownership via stock bonus. Ted is trying to decide between gifting and selling.

### Scenario No. 1 - Sale

In most cases, the business-active child has little or no money to buy the business. In this situation, a purchase is usually financed with a promissory note. In Ted's case, if Sharon purchases 20% of his stock for \$650,000, she will receive 20% of the distributions generated by the free cash flow, or \$200,000 per year, after the transaction. Sharon will owe about \$80,000 per year in income tax on company earnings assuming taxable profit is equal to free cash flow. This leaves her \$120,000 per year for promissory note payments. Assuming a conservative interest rate on the promissory note (5%), the note will be paid in full in about 6 ½ years (76 months).

Ted will receive total principal payments of \$650,000. Assuming Ted has virtually no basis in his stock, the transfer results in \$520,000 after a

capital gains tax of \$130,000 is paid. The total net taxes paid by all parties in this transaction, as compared to taxes that would have been paid by all if the transaction had not occurred, are essentially equal to the capital gains tax that Ted pays on receipt of stock sale payments, or approximately \$130,000.

It is important to note in this scenario that Ted received payments of \$650,000 - money that he really didn't need and a portion of which may well be part of his estate for estate tax purposes and therefore taxed at his death.

### Scenario No. 2 - Gift

Ted was leaning toward gifting ownership because he, like the majority of business owners, believed that he could simply "gift" ownership to Sharon. However, this strategy may not be as simple as it sounds and it may have unintended tax consequences. He may try to use the annual gift exclusion to transfer business interests, but even in this situation, a married business owner can only transfer \$28,000 worth of stock per year (based on 2013 allowable gifts). At this rate, it would take about 27 years for Ted to gift just a 20% ownership interest to Sharon; assuming no growth in value of the company.



If Ted chooses to transfer the 20% ownership interest to Sharon now, he can use part of his lifetime unified credit exclusion. The entire 20% ownership interest, with a value of \$650,000, can be transferred at one time with no immediate income, capital gain or gift tax consequence. The estate tax consequences will occur later; however, when another asset in Ted's estate, having a value of \$650,000, is subject to estate taxes because that portion of the unified credit was used in gifting ownership to Sharon. This results in an eventual estate tax of approximately \$292,500 at Ted's death.

## Final Thoughts

When you decide that the best exit route for you and your company is to transfer ownership to your

business-active child, it is important to understand the tax and other implications associated with each transfer technique. Although one of these transfer techniques may initially sound like the best option, each has its own potential tax disadvantages.

For more information or to learn how L. Harris Partners can help you plan your exit:



Phone 952.944.3303  
[tom.siders@lharrispartners.com](mailto:tom.siders@lharrispartners.com)  
[www.lharrispartners.com](http://www.lharrispartners.com)