

Implementing Your Business Transition Plan

Adapted by a presentation given by Galen Martin at an AF business seminar

You have probably heard the saying, “All good things must come to an end.” This applies to our lives on earth. No matter how successful we have been, someday all of our possessions and responsibilities will be handed over to others. Since this transition is impossible to avoid, it’s only reasonable that we plan for it. But planning is only part of the task; we must also *implement* the plan.

Business transitions are complex. In addition to assets, transitioning leadership and operational management are often part of business transitions. This article focuses on the transition of assets. It covers several transition options open to you, important considerations, and pitfalls you should avoid.

Getting Started

Sometimes the most difficult phase of a project is simply getting started, especially if the project is complicated, we don’t know where to begin, or we don’t enjoy the work.

Making a transition plan can be one of those projects. If you don’t know where to begin, start small. Bring it up in a conversation with a friend and ask about their plan. Reading this article is a start. Take workshops related to the topic such as those Anabaptist Financial provides. Talk to someone, such as your accountant or an advisor at Anabaptist Financial, who is accustomed to assisting with these types of requests and can point you in a good

direction. Avoid consulting people such as insurance agents who are trained in creating transition plans that increase their commissions.

As you collect ideas through conversations, reading, or professional advice, jot down some broad goals. For example, you might know that you would like your two sons to take over the business. Jot that down. Now you can explore what it would mean for that to happen. Maybe you are concerned that all of your children be treated equally. Jot that down. Maybe you want 20% of your estate to go to charities. Write it down. If your concern is finding a method that minimizes taxes, make a note of it. After you have listed your broad goals, you have something tangible to bring to an advisor who can help you sort out what is good for both the seller and the buyer.

Transition Options

Following are six common transition options that can be tailored to your specific situation. You may even use a combination of several options.

1. Sell during your lifetime. One drawback with this option is that collecting the entire selling price in one year may result in you owing a substantial amount of income taxes. As an alternative, you could collect the money over a period of years and pay tax only on the portion you receive during the year. However, this option of “electing

the installment method” is not available for equipment. When selling equipment, you must report that income the year of the sale. The equivalent to an installment method for equipment would be to agree with the buyer to sell the equipment over a period of time: a tractor this year, the combine next year, and so on.

The buyer benefits because he gets the deed for the property or the title to the equipment immediately. The property can be used as collateral or as security to the bank. He can also take depreciation on the depreciable properties such as buildings and equipment whether he has paid for it or not. Example: the buyer purchases the farm over fifteen years in installments. As the seller, you pay income tax on each installment, but the buyer can put it on their depreciation schedule for the whole price of the farm at once whether he paid cash for it or you financed it. (Land cannot be depreciated.)

2. Gift the business to your child/children. Gifting the business, typically the least complicated option, can be as simple as transferring the deed or preparing a document that states your wishes. You can do this any time before you die, even on your deathbed, provided you are in your right mind. You can also gift by selling the assets to your children at a discount. If the value of the assets is appraised at \$500,000 and you sell them for \$400,000, you’ve given the buyer the equivalent of a \$100,000 gift.

As with any transition, consult an expert so that you understand the legal details to be aware of. For example, it’s important that the recipient of a gift acknowledge that they accept it. Let’s say that I have an acre of prime ground along a busy highway that I want to give to you. Would you accept it? What if I revealed that the site contains toxic waste that will cost millions to clean up before you can use or sell the property? Will you still accept it? Probably not. This illustrates how a gift can become a liability, and the recipient can choose not to accept it.

Taxes are another reason for making sure a gift is accepted by the recipient. You may want to give an asset to a child so that it isn’t taxed as part of your estate. You can do this by writing up a statement saying you are giving it to your son or daughter. When they sign the document acknowledging that they accept the asset, it becomes their property and not part of your estate.

Understanding and navigating tax laws can be complicated. For example, when you gift assets, you won’t incur

income tax. However, if the recipient turns around and sells the property at the current value, he will be taxed on the difference between the selling price and your depreciated basis. Also, buildings and equipment that are gifted cannot be depreciated at their fair market value. Rather, they continue to depreciate based on your depreciated cost basis.

Finding a way to give each child an equal share can be difficult. It’s often not practical to give everyone an equal portion of the business, so owners sometimes give the business to one child at a discounted price and give cash to the remaining children. When the gifting is done years before your death, inflation comes into play. For example, suppose you sold the business to a son at a discount of \$100,000 with the promise that the other children would receive \$100,000 each upon your death. If you live another twenty years, the son who purchased the business received a \$100,000 gift twenty years before the other children, meaning that his gift is probably worth more than theirs due to inflation and the time value of money.

One option in this situation is to stipulate that the gift to the other children be adjusted according to a consumer index’s measure of inflation. Another factor to consider is that the son who received his gift in the form of a discounted purchase essentially saved \$100,000 *plus* the interest he would have needed to pay for a loan that size. To counter this advantage, interest could be added annually to the other children’s amount until they receive the cash as a gift.

On the other hand, the child who received the business early also takes on the risk of that business. If the economy would tank and the business loses value, the other siblings probably wouldn’t think it was unfair if they still got their \$100,000 gift. Although Jesus’s parable of the workers refers to eternal rewards, we shouldn’t forget the principle of being content with agreements that we make. Stipulate the terms up front when the first child receives a gift and ensure that everyone agrees to the terms.

3. Gift a portion to the children. You have several options for gifting a portion of the sale of your real estate to your children. First, you could sell the farm, collect the money, pay your taxes, and then divide the leftovers. Second, you could gift a portion of the property to the children before the sale. At settlement, each child would collect their portion. Sometimes the title is transferred to the children ahead of the sale; other times a document

is prepared before the sale in which the children and the buyer agree to the terms and sign it. At settlement, the children and parents receive the Form 1099 showing the sale proceeds. Each person pays taxes on their individual portion, thus spreading the tax costs over more taxpayers. This is an advantage because some of the children may fall into a lower tax bracket than the parents.

Property gifted retains its holding period. Therefore, the children qualify to have the sale taxed as long-term capital gains, just like the parents would have since they owned the property over one year.

4. Gift a portion of the property to charity. As Christians with a stewardship mindset we automatically think about how a portion of what we have can be given to a charitable organization to support the work of the church or missions. While our motivation goes beyond avoiding taxes, gifting to a charity does have distinct financial advantages. Like gifting to children, the gifting needs to take place prior to the sale with an agreement worked out with the buyer.

This type of transition is usually most beneficial with property, such as land and buildings that qualify for capital gains treatment. When a charity is the recipient of the gift, you can get a special, double deduction, since you can deduct the fair market value of the portion that you gave, as well as avoid paying tax on the gain of that gifted portion.

As with all loopholes and exceptions, there are limitations with this option (such as a limit to 30% of your adjusted gross income) that a professional advisor can help you sort through to determine what works best for you.

5. Rent with an option to purchase. This option is especially attractive to elderly people. The sale price is fixed, and the buyer has the option to purchase the property upon your death. The buyer pays all the repairs, real estate taxes, and expenses just like they own it, and can begin making payments toward the purchase price based on an amortization schedule similar to a loan schedule. Since the property hasn't been sold yet, the interest is classified as rent, and the principal is classified as down payment. These down payments are not taxable. So the seller only reports rent income.

For example, if the purchase price of the property is \$1,000,000, and the buyer pays \$400,000 as a down payment, the remaining balance on the principal is \$600,000. At a rate of 4%, the interest (called rent in this

Figure 1: Monthly rent payment example

Purchase price	\$1,000,000
Down payment	<u>-\$400,000</u>
Unpaid balance	\$600,000
Annual rate	x 4%
<u>Annual rent</u>	<u>\$24,000</u>
Monthly rent	\$2,000
Additional down payment	<u>\$1,000</u>
Total monthly payment	\$3,000

case) comes to \$24,000 annually, or \$2,000 a month. The buyer pays an additional \$1,000 toward the principal, bringing his total monthly payment to \$3,000 (see Figure 1). Because he is paying \$1,000 a month on the principal, the principal decreases slightly every month, and adjustments are made accordingly.

A drawback to this option is that the buyer cannot begin to depreciate the buildings until he actually buys them. However, if the seller agrees, the buyer can use the property as collateral.

6. Transfer the assets through your will. This is the default option and often the option of choice for those who are terminally ill. In one case the father discovered that he was terminally ill and rushed to sell his farm before he died. As a result, they ended up paying unnecessary income tax on the sale, which could have been avoided if he had written up an agreement and let the farm go to his heirs. The heirs would have received the property with a stepped-up basis equal to fair market value. When the property is sold, there is no gain and therefore no income tax. If the property is kept, they can begin depreciating everything at the fair market value of the buildings, equipment, etc.

Some states have an inheritance tax. In Pennsylvania the tax is 4.5% if the property goes to the children. If it goes to the siblings of the deceased, it is 12%. If it goes to nonrelatives, the tax is 15%. If it goes to the wife or charity, the tax is 0%. For this reason, if a wife can show that the assets were owned solely by her deceased husband, she can put the fair market value of all equipment on her depreciation schedule and start depreciating all over again. Or she can have sale without income tax because it was valued at the fair market value on the date of the death. On the other

hand, if the husband and wife jointly owned everything, federal tax laws allow her to get stepped-up basis only on his half, not hers. PA state law does not give any stepped-up basis in that case.

Transition Timing

As you have seen in the transition options, the sale date and the payment schedule are important considerations for both seller and buyer. For the buyer, seller financing often includes lower interest rates and more flexible terms. For the seller, the timing can make a significant difference in the taxes he will pay. See Figure 2 for a sample 2019 tax rate schedule for a married couple filing jointly (see Figure 2).

Note how the rates increase in correlation with income and how they vary depending on whether the income is classified as regular, capital gains, or depreciation recapture. A tax professional can help you navigate your options and keep income in the capital gains column without getting into a higher bracket.

Ten Pitfalls to Avoid

To conclude, be aware of the following pitfalls that you should avoid.

1. **Procrastination.** Do not leave it to those who are left behind to finish your unfinished business. You have a better grasp of it than they do. Be considerate and take care of it while you can.
2. **Unsigned documents.** You would be surprised at the documents that have been prepared many years prior but were never signed because the owner expected to make a few tweaks.
3. **Outdated wills.** If your will is not up to date in expressing your wishes, take the time to make it current.
4. **Handwritten documents.** There's nothing wrong with handwritten documents, but sometimes these

Figure 2: Tax rate schedule (2019) for married couple filing jointly

Taxable Income	Regular Tax Rate	Capital Gains	Depreciation Recapture
Up to \$19,400	10%	0%	10%
\$19,400–\$78,950	12%	0%	12%
\$78,950–\$168,400	22%	15%	22%
\$168,400–\$321,450	24%	15%	25%
\$321,450–\$408,200	32%	20%	25%
\$408,200–\$612,350	35%	20%	25%
Over \$612,350	37%	20%	25%

documents are neither thorough nor clear. Take that handwritten document and ask someone to read over it and see if it makes sense. It doesn't have to be wordy or fancy, but it needs to make sense and be unambiguous.

5. **No buy-sell agreement between business partners.** If you're in a partnership, have you negotiated what should happen if one of you dies? What does his widow get? Is there goodwill to be paid? Is there seller financing? Can shares of the business be sold to nonfamily members? Working out these details beforehand avoids a lot of frustration and hard feelings later.
6. **Excessive loans to children.** Do not loan a child more than what you expect their share of the estate to be. It puts a burden on sibling relationships when the other siblings receive less because one sibling borrowed more than their share of their inheritance. It didn't go well with Joseph and his brothers when Jacob treated them unfairly.¹ It's still that way today.
7. **Premature gifting of estate.** There's risk involved when parents who are still living gift too much of their estate to their children. As long as you are alive, you face the possibility of unexpected medical costs or reduced

¹ Genesis 37:3-4 "Now Israel loved Joseph more than all his children, because he was the son of his old age: and he made him a coat of many colours. And when his brethren saw that their father loved him more than all his brethren, they hated him, and could not speak peaceably unto him."

income.

8. **Irrevocable charitable remainder trust.** This isn't referring to living wills or living trusts, but to irrevocable trusts that you can't reverse. Make sure that you have access to that asset if an unexpected event occurs.
9. **Unrealistic net worth.** What we own often has more value to us than to someone else. Failing to realistically evaluate the net worth of your estate and making decisions accordingly can be embarrassing—and worse. It can change how much money you have available in retirement because what you planned to live on is simply not there.
10. **Unitemized sales agreements.** All sales agreements (with the exception of corporate stocks) should break

down the selling price of all the components. Because each item has an acceptable high or low market value, when itemizing the values of each item for tax purposes, the seller's numbers should match the buyer's numbers in case of an audit. The seller tends to choose different numbers because they affect his tax rates differently than they do the buyer who is listing the same items.

Careful and thoughtful planning increases the likelihood of a successful transition. Implementing that plan may seem overwhelming, but when you get started it's not as difficult as you may expect. Remember that this transition *will happen*; it's just a question of when. Transition plans are too often developed but not implemented until the owner's death, forcing their successors to make key business decisions during a difficult and emotional time, often with little experience. The purpose of this article is to help you get started finding and implementing the right transition plan for you and your loved ones.



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