Effective Tax Planning for Your Family Business Succession

Tax Partner at PwC Ireland, Teresa McColgan, and Tax Director at PwC Ireland, Niall Cogan impart advice on the transfer of ownership of family businesses from a tax perspective.

Introduction

In our article on *Leadership and succession planning* in the April 2017 ezine, we talked about the need for current leaders to plan for their own financial health and future roles, if any, in the business as they make way for their successors. We also outlined how those leaders can help the next generation prepare to take on leadership roles.

In this article we address the need to plan properly for the transfer of ownership of family businesses from a tax perspective, to ensure that any tax liabilities arising are minimised and can be funded.

In situations where there isn't appropriate planning, unexpected tax liabilities may arise that could be significant and have a direct impact on the financial wellbeing and viability of the business.

The succession process is something which should, ideally, be carefully planned over several years and similarly the various tax reliefs designed to minimize any tax arising on the business transfer should be identified and understood well in advance.

Every situation is different, not only because of the different types of business and assets involved, but also because of different family visions and cultures, business strategies and innovation, perspectives on who should own shares, skills available within the family, willingness to involve professional management etc, and so the plan has to be tailored to the particular circumstances. But, as mentioned above, there are tax reliefs available to help facilitate the transition and we hope that this article gives a flavour of those reliefs, as well as potential pitfalls, as we illustrate their use by way of a number of example case studies.

The succession plan

In assessing the tax implications arising, the plan needs to include specific details on the following:

- What assets, including % ownership, will form part of the succession plan?
- What family members will participate in the transfers (both transferors and transferees)?
- When will the transfers take place and what age will each transferee and transferor be on the date of transfer?
- What will the estimated market value of each business asset be on the date of transfer?
- What consideration, if any, will be payable for the transfer of the business assets?
- When will the consideration be payable and will some element be deferred?

- How will the consideration be funded, either personally or through retained profits of the business?

As business owners will appreciate, the answers to the above questions may take some time to determine and will continue to evolve in response to the financial performance of the business and to the personal, including financial, circumstances of the existing and new shareholders.

The tax considerations

Irish tax policy is generally supportive of businesses transferring between generations, and our legislation contains several tax reliefs which are designed to minimise tax payable on such transfers. These reliefs relate to Capital Gains Tax (CGT), a tax that applies to the person disposing of an asset (including a transfer by way of gift – market value consideration is imputed on transactions between connected parties), and Capital Acquisitions Tax (CAT), a tax that applies to a person receiving an asset by way of gift or inheritance tax. Both taxes apply at the rate of 33%. Where both taxes arise on the same transaction the CGT may be set off against the CAT.

Professional tax advice should be sought as part of preparing the succession plan and your tax adviser should consider the following:

- Is it possible to access tax reliefs to minimise any potential CGT payable by the existing business owner? This is known as retirement relief, though there is no requirement for the transferor to retire from the business to avail of the relief.
- Is it possible to access tax reliefs to minimise any potential CAT payable by the next generation of business owners? This is known as business property relief, and it applies only to qualifying business assets.
- What are the qualifying conditions for each tax relief and, importantly, for what period do they need to be satisfied?
- Is it worth reorganising the corporate structure in order to maximise the tax reliefs available and to provide flexibility if the succession plan changes in the future?
- When is the optimum period to transfer business assets between family members?

The qualifying conditions for these tax reliefs can be onerous, particularly for those who have not given adequate consideration to the qualifying conditions at an early stage. The CGT relief caps introduced in 2012 for disposals made after age 65 have not been helpful in this regard. The tendency in many Irish families to let profits generated by the business continue to accumulate in the trading company, so that it effectively reflects most, if not all, of the family wealth other than the family home, can also be problematic. Not only can it mean restrictions in the level of tax reliefs, it can also compromise the viability of the business as it moves to the next generation, if there are not clear plans for segregation of ownership and management.

Formalising wealth management and asset diversification is an issue that many Irish businesses fail to address. While a strong balance sheet is clearly helpful in terms of supporting the business, as indicated above, there are potential disadvantages beyond the burden of a business struggling to provide financial support to family members who are not contributing to its activities.

There is also the issue of asset protection. The wealth accumulated by generations could be at risk if measures are not taken to protect it from exposures in the event of future business problems.

Having everything tied up in the business can also lead to poor decisions with regard to wealth transfers, particularly where parents think that looking after their children fairly means looking after them equally. All too often this means that shares in the business are allocated equally among the children, not all of whom are actively involved in the business. This can lead to family tensions, as their financial objectives are likely to be very different. Those actively involved in the business are generally more likely to make short or medium term sacrifices for the longer term development of the business, while those who are (only) shareholders often want a more immediate return, by way of annual dividends or an opportunity to covert their shareholdings into cash.

To compound maters, the accumulation of “excess” cash or investment assets within the business can lead to excessive tax liabilities. Tax reliefs that support business transfers within families can be diluted or lost entirely, depending on the extent to which the business asset’s value is attributable to these investment assets.

The following example illustrates the potential costs if the issue is ignored.

Example 1 – impact of asset ownership structure on gift and inheritance tax liabilities

Take parallel business families whose accumulated wealth is each valued at €25m, each family with five children, two of whom are actively involved in their respective family businesses. The core business, including sufficient cash to support the business, is valued in each case at €10m, and other assets and investment held, including investment property, is valued at €15m. All of Family A’s assets are held by the family trading company, while Family B’s trading company holds only the core business assets, their other assets being owned outside the business. Let’s say the parents in both families decide to share their wealth equally among their five children.

No business property relief will be available on a share transfer in Family A, as more than 50% of the share value relates to nonbusiness assets. Each of the five children will face a tax liability of at least €1.55m on inheriting the shares. If they have to withdraw cash from the business to pay the tax, that withdrawal in turn will give rise to significant income tax liabilities for which the withdrawal required will need to be re-grossed. The net result will be a significant erosion of the business value.

The tax cost would be substantially lower for Family B, whose wealth has been segregated so that the non-core assets are held outside the family business company. If the shares in the business go to the two children involved in the business, qualification for business property relief means that their individual tax liabilities should be less than €165K – a saving of over €1.3m for each of them. *(Note this example ignores any CAT thresholds available)*

While Family B’s other children would still potentially face significant tax liabilities, this should not affect the business, as a disposal of some of the assets inherited would generate proceeds to enable them to pay that tax.

It is worth noting that, as this example illustrates, while parents may decide to make transfers of equal value, the after tax values of transfers can be quite different. However, the nature of the assets acquired, the responsibilities attached and their liquidity can be quite different too, and these are all factors that parents involved in family businesses need to take into account when deciding what is fair (rather than what is equal).

Example 2 – impact of timing of ownership transfers

Patrick has shares in a family company owned 50/50 with his brother John. Patrick's shares are valued at €5m.

Patrick's daughter, Sasha, currently works in the business and Patrick would like to transfer his shares in the business to Sasha.

Patrick is aged 63 but is not ready to retire and is unsure when he should transfer his interest in the business to Sasha.

Option 1- Transfer now aged 63

	€
CGT payable by Patrick*	NIL
CAT payable by Sasha*	62,700

Option 2 Transfer in 3 years when aged 66

	€
CGT payable by Patrick*	660,000
CAT payable by Sasha*	NIL

The tax cost associated with Option 2 is significantly higher as Retirement Relief is restricted for individuals who are aged 66 or greater when transferring business assets.

**Assumes conditions for Retirement Relief and Business Relief are met*

Common pitfalls

As illustrated by the above examples, the tax cost associated with business transfers can be penal where careful planning is not undertaken and professional advice is not sought.

Common pitfalls encountered include the following:

- Failure to satisfy the conditions for CGT relief for the required period - the relief includes conditions, some of which need to satisfied for a 10 year period prior to the business transfer.

- Delaying the transfer of the business until after the existing shareholder reaches 66 years of age - retirement relief places a restriction of the value of businesses which can transfer between family members tax free once the existing shareholder reaches 66 years of age

- Missing the opportunity to restructure the business to ensure tax reliefs can be availed of - for example separating trading from investment assets in a timely manner.

- Business is sold by the next generation- the main CAT relief requires that the business continues to be held for at least 6 years to prevent a clawback of the tax relief.

- Failure to consider changes in tax law in the period between making decisions and implementing them - if tax laws change before ownership of the business is transferred to the next generation it could result in unanticipated tax liabilities if tax reliefs are restricted and appropriate action is not taken.

Summary

While tax planning is just one element of a succession plan it is an important one, and if not dealt with correctly and in a timely manner, the tax costs can jeopardise the business.

The tax reliefs available on business transfers can be generous, but the qualifying conditions do need to be understood and appropriate steps taken to ensure they are met at the appropriate time and for the appropriate period.

As the availability of reliefs is fact specific, it is important that each family business takes professional advice that is tailored to their circumstances. We've seen expensive mistakes where people have taken shortcuts on this and assumed that the plan followed by others will be appropriate for them, without considering whether they meet the qualifying conditions for the various reliefs. While tax should not be the driver of what is a commercial decision to facilitate the continuity of the business into the next generation, it is important that the succession plan is devised in conjunction with the tax advice rather than before or after it.

Achieving a tax neutral business transfer is the optimum outcome for both the shareholders and the business, and with appropriate and timely tax advice this can often be achieved. This will help to ensure both the ongoing viability of the business and the successful implementation of the succession plan.

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