Key Family Wealth – Business Advisory Services (BAS)

Tax Moves for Business Owners Before the Year Ends

The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

Year-end tax planning holds immense significance for business owners gearing up to transition their businesses. It offers a strategic opportunity to evaluate financial outcomes, especially in the context of a business sale. Engaging in strategic tax planning in the years before a potential sale allows business owners to leverage deductions, credits, and exemptions effectively, ensuring they comply with tax regulations while retaining a substantial portion of the sale proceeds. Meticulous year-end tax planning is a crucial step that can significantly impact the financial success of a business sale, allowing owners to make informed decisions and optimize their overall financial position.

There are four areas of tax that business owners need to be focused on during a transaction: transfer taxes, business and capital gains taxes, state and net investment income taxes, and post-sale taxes. Each area of tax should be incorporated into your year-end tax analysis if saving taxes is an important topic for a business owner.

However, at what point — in the course of events leading up to a sale — does it become too late to implement pre-sale tax savings strategies and still benefit from favorable tax treatment?

Sophisticated tax minimization strategies can undergo thorough examination by the Internal Revenue Service (IRS), especially when they are put into place the same year as the business is sold. For strategies put in place in the year of sale, the IRS will look to see if the facts and circumstances show the strategy was purely for tax avoidance and served no other purpose, they could look through the strategy as if it was never put into place, and the owner would be subject to interest, fines, and the taxes they never paid.

When tax planning is done in advance the strategies available are endless. Charitable vehicles are very popular tools used to redirect dollars from taxing authorities to philanthropic entities – often providing owners with benefits in the form of tax deductions and income streams.

Business owners don't necessarily need to have deep philanthropic experience — or even have the desire to be hands-on in their charitable giving — to take advantage of these strategies. In some situations, owners can obtain more cash over a certain number of years by using certain charitable strategies than the value of the stock they put into the strategy initially.

Charitable gifts serve as impactful tax savings strategies for individuals and businesses alike. By donating to qualified charitable organizations, individuals can potentially lower their taxable income, which in turn reduces their overall tax liability, although the timing must align with tax regulations. Waiting too long or making donations after critical cutoff dates can result in missed opportunities for tax benefits.

Therefore, understanding tax laws and planning charitable contributions strategically within the fiscal year's time frame are essential to optimize these tax-saving opportunities. Proper timing ensures individuals and businesses not only contribute to meaningful causes but also make the most of their charitable giving in terms of tax advantages. When implementing these strategies to maximize the benefit for the business owner, reducing capital gains taxes and obtaining charitable deductions tend to be the two leading tax benefits.

Another reason that planning can be more effective is the relative difference between eliminating a capital gain versus obtaining a deduction against a capital gain. For example, placing appreciated C corp shares inside a charitable remainder trust presale, when done properly, eliminates the capital gain in the year of sale, providing installment treatment to the donor as the trust distributions come out to the owner. Selling the same C corp shares and then contributing the cash to a charitable lead trust in the year of sale — again, when done properly — provides a dollar-for-dollar deduction against the gain, but the seller is limited to deducting only 30% of the gift to the trust in the year of sale. The net result? The owner in the first case pays tax on 0% of the capital gain in the year of sale, and the owner in the second case pays tax on 70% of the capital gain (less any deductions for the contribution to the charitable trust, and the individual circumstances of the taxpayer). Timing — and charitable vehicle — matter. Too often the charitable planning is only used as a post-tax solution, which results in business owners only getting a tax deduction but having to pay capital gains tax (20% at the federal level). Year-end tax planning done a year in advance can potentially eliminate part of the capital gains tax due, along with obtaining a tax deduction.

Here are a few things to consider:

- A donor is entitled to an income tax deduction tied to the "fair market value" of the donated stock when the beneficiary is a public charity or when marketable securities are donated. In the year of a sale, a business owner's income is generally significantly higher than in any other year. Finding strategic ways to take advantage of tax deductions while still generating an income stream can be very attractive to many business owners.
- The donor pays no tax in the year of sale for the assets placed inside the charitable trust prior to sale. Instead, the capital gain typically comes out pro rata with the distributions from the trust. Timing is everything with this benefit. If you try to implement strategies too close to a transaction, the IRS may view the strategy as too aggressive and assess interest and penalties to the owner's unpaid tax bill. Best practice is to implement tax minimization strategies in the year before a transaction.

If you are planning a transaction in 2024, then you still have some time to implement tax minimization strategies before the end of 2023.

For more information, please contact your advisor.

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