Family Business Transfers in Inflationary Times

by Mairéad Hennessy

All business owners must at some stage consider when they will be ready to let go of the reins of their business. Business succession is a complex and sensitive matter and may be done gradually over a number of years. For most business owners their largest and most important asset is their business. As such, it is imperative that the necessary time and consideration is given to the owner's eventual exit. This exit may include a transfer to the next generation of a family, a sale of the business to management or a third-party sale.

It is not uncommon for business owners to hesitate to implement a succession plan for their business. However, business owners should be made aware by their advisors that failing to plan can often cause increased tax costs in the eventual passing of the business to the next generation. To ensure the continuity of the business into the future, succession planning should be part of the overall business plan.

The first steps on this process are to identify the most suitable successor or successors for the business and to ensure that the financial independence of the business owner in retirement is protected.

Setting the Scene

Where a decision to pass a business onto the next generation in a family is made, a question that frequently arises is whether this should happen by way of lifetime gift or inheritance. In general, it is never too early to pass to the next generation if this makes sense for the family taking into account the age and relevant expertise of the identified successor or successors for the business.

The benefits of passing the business by way of lifetime gift instead of leaving it pass by inheritance at an uncertain future date include:

- A gradual and planned handover of the business can be implemented.
- The value of the business at the date of transfer can be determined with certainty in the case of a gift. Tax costs are based on the value of the assets comprised in a gift. For this reason, knowing the value of the business at the date of the gift provides certainty to the parties regarding the tax liabilities that will arise on the transfer and also the tax reliefs available to reduce or mitigate these taxes.
- Importantly, where an asset, such as a business is transferred at its current valuation then future increase in the value of the asset will grow tax free under the ownership of the next generation. This is a significant consideration for business owners who are seeing the valuation of their business increase in the current inflationary climate. In this scenario, it can make sense for the business owner to transfer the ownership to the next generation as a lifetime gift in the near to medium term so that future increases in the business value will accumulate tax free under the ownership of the next generation.

There are financial, legal, tax and commercial considerations that must be dealt with appropriately in order to ensure the business handover is successful. The current inflationary climate is focusing the minds of many business owners who see the value of their businesses increasing. However, tax efficiently gifting a business requires availing of tax reliefs, all of which have stringent conditions attaching. For this reason, detailed planning is needed to maximise the potential for both the business owner and the successor(s) to avail of the relief so that the business handover is executed as tax efficiently as possible.

This article provides an outline of the relevant tax issues for the passing of a family business to the next generation as a lifetime gift. In the context of this article, the family business may be carried on as a sole trade, private limited company or as a partnership.

The tax headaches

The two main tax heads to be considered when business assets (including company shares) are passing from one generation of a family to the next by way of gift are Capital Gains Tax (CGT) for the current business owner and Capital Acquisitions Tax (CAT) for the younger generation who receive the assets. Stamp duty should also be considered especially where commercial property is being transferred as duty at 7.5% of the market value is levied on the recipient. It is also important that VAT is considered, especially where there is property passing as part of the asset transfer.

This article will focus on the CGT and CAT reliefs but due consideration to other tax heads must be given when advising clients.

Capital Gains Tax (CGT) Reliefs

The prevailing CGT rate is 33% and this applies to the gain made on the gift of the business to the children. Where the business is carried on through a company which the business owner incorporated, then this gain is the value of the business at the date of the gift.

Such valuation must be independently prepared as the transfer is between connected parties. If no reliefs can be claimed, CGT can present a significant tax cost for the business owners which is why it is so important that advance planning is undertaken so that the business owner has maximum opportunity to avail of CGT relief to reduce or eliminate this CGT cost.

Assuming the business is personally owned by the business owner (i.e. there is no holding company structure in place) then the relevant CGT reliefs are

- Retirement Relief
- Entrepreneur Relief

Retirement Relief

With careful planning, a business owner can avail of Retirement Relief to secure total CGT exemption on the transfer of the business to the next generation. Despite the name of the relief, business owners are not required to retire and can continue to run their business after they claim the relief.

Broadly, where the business owner is aged 55 or over and various other conditions are met, the business owner may be able to pass on his / her business without paying any CGT.

Key to availing of this relief is early planning as key conditions of the relief are time sensitive such as the working time director test which is ten years. Also, for businesses carried out through a trading company pre-transfer planning may be needed to remove investment assets from the Balance Sheet as these assets will reduce the value of Retirement Relief available. Depending on the complexities involved, such restructuring can take quite some time to implement.

When the business owner reaches the age of 66, the value of the business that can be transferred to a child of the business owner capped at €3m for Retirement Relief purposes. As such, it may be more beneficial from a Retirement Relief perspective to transfer the business sooner rather than later.

Entrepreneur Relief

As previously noted, the prevailing CGT rate is 33% however where a business owner meets the conditions for Entrepreneur Relief a reduced rate of 10% applies up to a lifetime limit of €1 million. This could result in a maximum potential relief from CGT of up to €130,000 in the business owner's lifetime.

Again, certain conditions apply, including:

- The business owner must own a qualifying business for a continuous period of 3 years any time prior to the disposal of the business assets.
- Where the business is carried on through a company, the owner
  - must own more than 5% of the ordinary shares in a qualifying company; and
  - must have been a director or employee of the qualifying company and spend more than 50% of his/ her time working for the company in a managerial or technical capacity for a continuous period of 3 years in the 5 years prior to disposing of the shares.

Capital Acquisitions Tax (CAT) Reliefs

Where a business successor receives a business either as a gift or for consideration at undervalue, CAT must be considered. The current lifetime tax free thresholds for gifts or inheritances from a parent to a child is €335,000 and any value in excess of this amount is potentially a CAT liability for the successor at the rate of 33%. Where such liability arises for a business successor, it can present a significant deterrent to succession planning as the successor may not have funds available to pay the tax. For this reason, careful planning to ensure that valuable CAT reliefs may be availed is crucial.

In this regard, the CAT reliefs for to consider include:

- Business Relief
- Agricultural Relief

As with the CGT reliefs, a number of conditions must be met in order for CAT Business Relief or Agriculture Relief to be met. However, where these reliefs apply, they are very valuable for the successor. Business relief provides for a reduction of 90% of the taxable value of a gift or inheritance meaning that the tax rate is effectively reduced from 33% to circa 3%.

Agricultural relief is similar except that it relates to the transfer of a farming trade. To qualify for the relief the beneficiary must be a "farmer" within the meaning of Section 89 CATCA 2003. One of the conditions for Agriculture Relief to apply is that at the date of the gift at least 80% of the market value of all the property to which the successor is beneficially entitled in possession must consist of agricultural property. To ensure this relief applies in an inflationary environment it is advantageous to have the date of transfer as soon as possible.

Final Comment

Open communication about the business succession plan between the exiting owner and the successors is extremely important. The current rising market means that the value of many businesses is increasing and unnecessary delays in implementing a succession plan will potentially trigger tax costs that could otherwise be avoided. Another important tax point is that there are 6 years clawback periods attaching to many of the reliefs discussed above (e.g. CGT Retirement Relief, CAT Business Relief and CAT Agriculture Relief). Where these clawback periods are not complied with, the tax cost triggered is levied on the successor meaning that this is an important consideration when deciding on the timing of implementing the succession plan.

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