Passing the assets of your financial services business to anyone, including family, without recompence qualifies as a substantial gift reflecting a large dollar value. Monetary gifts of this size have tax implications on several fronts. Below are a couple common pitfalls advisors experience when gifting their businesses to a successor rather than selling ownership with proper compensation, documentation, and due diligence.

GIFT EXCLUSIONS AND 2018 TAX LAW

The annual gift exclusion for 2018 is $15,000. That means that as an individual, you may gift up to $15,000 per person in 2018, and there will be no tax consequences for either party. However, if your gift to any one person exceeds $15,000, the excess amount will be applied against your lifetime estate tax exemption. Under the 2018 tax law, the federal estate tax exemption is $11,200,000 for individuals and $22,400,000 for married couples. State estate tax exemptions vary from state to state and, typically, are much lower than the federal estate tax exemption.

As an example, if an unmarried individual dies in 2018 and has made gifts to multiple individuals during his lifetime totaling $8,000,000 (including his $7,000,000 financial advisory practice to his children), only $3,200,000 of the remainder of his estate will be exempt from the federal estate tax. The remainder of his estate that exceeds $11,200,000 will be subject to his applicable state estate tax and up to a 40% federal estate tax.

If you make a sizable gift during your lifetime, it is advisable that you obtain and submit to the IRS an appraisal to substantiate the value of the gift. Be aware, an IRS-qualified appraisal of a business can cost anywhere from $5,000 to $30,000.

LONG-TERM CAPITAL GAINS IMPLICATIONS: GIFTING VS. SELLING

If you gift your practice to your intended successor, your basis in the business will transfer to them. This means when you built your business from scratch and did not purchase your client accounts from another advisor, your basis in those assets is zero. If you then gift those assets, your successor's basis in those assets is also zero. When they sell those assets in the future, they will pay long-term capital gains (at some future rate) on the growth you created during your lifetime AND the growth they created during their lifetimes.

However, if you sell your assets during your lifetime, you will pay long-term capital gains only on the growth you created at current rates. Through the sale, your successor's basis in the assets will step up to the amount they paid for the business. When they are ready to retire and sell the business assets, they will only pay long-term capital gains on the growth they created from the time they purchased the assets from you. With this strategy, you can capture value that you built during your tenure as owner at current, preferred tax rates and avoid sticking your successor with taxation of growth before their time as owner(s) at rates that could increase substantially in coming years.

An added benefit of selling assets to a successor vs. gifting—especially in a gradual, incremental transition of ownership—is that you allow them to put their money where their mouth is, as it were, by financially proving their investment in the business.