



BUSINESS SUCCESSION CONSIDERATIONS UNDER THE TAX CUTS AND JOBS ACT OF 2017

By Elizabeth M. Hollis

Many family business owners do not have a succession plan in place despite the fact that the business might be one of their most significant assets. According to a 2017 PricewaterhouseCoopers survey, only about one-third of family business owners have a succession plan, while just 23% have a formalized, documented succession plan. With the substantial changes to the tax code under the Tax Cuts and Jobs Act of 2017 (the "Act"), it might be an optimal time to consider how business ownership should be passed to the next generation. This article identifies new tax provisions that family-owned businesses should consider in light of the changes made under the Act.

Estate and Gift Tax Considerations

An important update under the Act is the adjustment made to the federal estate and gift tax exemption (the "Exemption"). The Act effectively doubled the unified federal estate and gift tax credit, with an individual's Exemption previously set at \$5 million now set at \$10 million (both inflation adjusted). In 2019 the Exemption is \$11.4 million per person, which is set to increase until the Exemption sunsets in 2025. Although the Exemption changed, the remainder of the estate and gift tax code,

including the generation-skipping transfer ("GST") tax and portability provisions, stayed the same.

The adjustment to the Exemption provides some gifting opportunities for family-owned businesses. Business owners with estates close to the Exemption limit might consider gifting a business interest to the next generation with the expectation that he or she will eventually control the business. Under this strategy, business owners may pass along complete or partial ownership of their company, while reducing tax liability. The concept allows the gifted business interest and any growth attributable to that gifted interest, to be sheltered outside the estate of the business owner, which reduces his or her taxable estate. Business owners who have already maxed out the previous \$5 million lifetime exemption amount may now be able to continue or accelerate their gifting strategies and further reduce the taxable value of their estates. An additional consideration is whether the business owner wants to take advantage of a step up in income tax basis. If a business interest is already owned in an irrevocable trust, for example, a business owner might consider substituting high cost basis assets with low cost basis assets to take advantage of an income tax step up on the death of a

beneficiary. If gifting is a priority, it will need to happen before 2026. The IRS stated that there will be no clawback of the use of the Exemption before 2026 when the Exemption reverts back to \$5 million; therefore, timing is essential.

Before gifting some or all of the business to a family member, it is recommended that the business owner has a serious discussion with the individual he or she plans to gift to. It is possible that a family member may not be interested or does not want the responsibility of taking control and continuing the business. If the business owner decides to gift an interest, it is important to take a look at the business' underlying documents to ensure restrictions on transfer or right of first refusal provisions are incorporated. This will ensure that if a family member decides to sell his or her share, it will first need to be offered to the other owners.

A business owner should also consider the underlying assets of the business when gifting. While gifting interests to family members or key employees may reduce an owner's taxable estate, it could cause a reassessment of the business' real property if the gifting causes a change in ownership or a change of control under California's Revenue and Taxation Code. Therefore, it is advisable that the business owner seeks experienced counsel before changing the ownership of the business.

Income Tax Considerations on Business Entities

Although not directly related to succession planning, the Act dramatically shifted business taxation, which might affect the business structure. C Corporations now pay a flat rate of 21%, which is significantly lower than the previous 35%. Additionally, the corporate alternative minimum tax is fully repealed. For pass-through entities (i.e. partnerships, limited liability companies,

S Corporations, and sole proprietorships), there now exists a potential 20% deduction of qualified business income ("QBI"). Due to particular limitations, only certain pass-through entities will be able to utilize this deduction, as there are both income threshold limits and profession restrictions that a business owner will need to meet.

Although there may be restrictions in place, certain opportunities may still exist. Professionals who invest in non-excluded ventures, such as real estate holdings, may take the opportunity to increase investment in such non-service related ventures in order to utilize the deduction on future income derived from those non-service related ventures. Also, if a professional is involved in a non-service-related family business, the professional may wish to increase income opportunities through the family business and take advantage of the deduction. In addition, businesses that may be in a growth period, and wish to retain earnings and not distribute dividends to investors (i.e., family members in a family business), may wish to convert to a C Corporation so that the corporate income is taxed at the much lower rate.

The Act provides some exciting opportunities for family-owned businesses. The business owner may wish to utilize lifetime gifts of business interests to younger generations to leverage the Exemption while also potentially reorganizing the business to utilize the lower corporate rate or the pass-through deduction. The Act, as it relates to the estate and gift tax exemption, is set to sunset in 2025; therefore, business owners looking to take advantage of this opportunity to secure a wealth and business succession plan while maximizing the available income tax reductions should do so before it expires.



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