Family Business Survival Strategies in an Era of Sweeping Tax Reform

Changes to our nation's income taxes, capital gains taxes and estate taxes – whether already passed or still in the proposal stage – pose massive challenges for family farms and other family businesses. In such an era, it's good to know you still have tools at your disposal to protect your interests, or even your way of life.

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The family business, in the best of times, faces unique challenges, particularly with business succession and estate planning. Moreover, the family business is often not merely a business, but a lifestyle. The hard work, long hours and heightened risk can be common challenges. The business owner's very identity is more likely to be tied to the success, or failure, of the family business.

This is particularly evident for agricultural or farm businesses. The family farm is connected to the land, which is critical to success. In California, where our

firm is based, the news is replete with stories of fires and critical water shortages as our mega drought continues.

In addition to such forces of nature, family farms and other family businesses face another threat: An increasingly inhospitable tax environment. First, let's examine some of the changes in the wind. We must all remember that these are all simply proposals, and any final tax changes may be dramatically different. We remain uncertain that the Biden administration has enough votes to enact any truly meaningful tax change. Predictions are always tricky — consider how accurate the pollsters were in the 2016 and 2020 presidential elections.

That said, this examination is timely as the House Ways and Means Committee (House W&M Committee) released its proposed tax changes on Sept. 13. Note that most provisions would be effective Jan. 1, 2022. However, caution is needed as some provisions would have an earlier effective date. We'll explore the changes that are particularly meaningful for the family business further, but some highlights of the House proposal include:

- Increasing top individual rate to 39.6% and the top capital gain rate to 25%
- A new 3% surtax for individuals with adjusted gross incomes (AIG) over $5 million
- Lower estate and gift tax exemption beginning Jan. 1, 2022
- Changes in the treatment of Grantor Trusts

The House W&M Committee's proposal (**click here** for the text of the committee's report) is just one of many we've seen recently. In addition to this most recent proposal, there's President Biden's **American Families Plan**; the **Sensible Taxation and Equity Promotion Act of 2021** (the STEP Act), introduced by Sen. Chris Van Hollen (D-Md.); and Sen. Bernie Sanders' (I-VT) **For the 99% Act**.

A Look at Challenging Changes for Family Businesses

Each of these plans has elements that affect family businesses in different ways. Here is a wrap-up on some of the major changes that are either proposed or recently implemented.

Proposed: Higher Marginal Rates for Ordinary Income and Capital Gains

Mentioned by more than one of the recent tax proposals, the potential return of the 39.6% tax rate (up from the current 37%) could affect the bottom line of

profitability of the family business. The economic pain is worsened with higher tax rates in many states. For California residents, a 13.3% state marginal tax rate results in a top overall combined marginal tax rate of over 50%. New York State residents pay 8.82% state income tax for a combined rate of 48.42%. A resident of the city of New York will pay an additional 3.816% for a combined rate of 52.296%.

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In addition, potentially higher capital gains rates may also be on the horizon. Under current law, **long-term capital gains rates** for those filing as individuals are as follows:

Percentage	Income – Single	Income – Married Filing Jointly
0%	$0 to $40,400	$0 to $80,800
15%	$40,401 to $445,850	$80,801 to $501,600
20%	$445,851 and above	$501,601 and above

The House W&M Committee's proposal includes an increased top capital gains rate of 25%. And **President Biden proposed** that, for taxpayers with "income" (a term as yet undefined … gross, adjusted gross, net? Does income include the capital gain itself?) of $1 million or more, capital gains would be taxed at the 39.6% rate for ordinary income.

Already Implemented: The Loss of the Stretch IRA

In future years, $1 million in income (however defined) will be easier to reach because of the Secure Act, which was signed into law by President Trump and went into effect on Jan. 1, 2020. The Secure Act effectively **eliminated the stretch IRA**. Prior law allowed planners to defer, or "stretch," tax on retirement accounts for multiple generations. The Secure Act essentially imposes a 10-year limitation upon the death of an account holder, with **very few exceptions**. That means those who inherit an IRA must completely drain the account within 10 years, likely generating higher tax bills for them.

Proposed: RMDs for 'Large' IRAs

The House W&M Committee appears to require "large" IRAs — generally understood as those that exceed $10 million as of the end of the prior taxable

year — to immediately be required to begin minimum distributions. These distributions would be taxable as ordinary income.

Proposed: The Potential Loss of the Basis Step-Up

Even the sacred "step-up in basis" for inheritors is at risk under Biden's American Families Plan. Currently, when property is sold, the taxable gain is determined in simplest terms by subtracting the cost, or "basis," from the purchase price. If property is inherited, the cost basis is increased to an amount equal to the fair market value at the date of death. For appreciating properties held over a long period of time, this will be a substantial amount. The American Families Plan proposes to limit this step-up in basis.

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The Biden proposal permits a $1 million per person or $2 million per married couple to be excluded. This $1 million/$2 million exclusion is in addition to exclusions for property transfers to a spouse, charities, capital gain on certain small business stock, and the current exclusion of $250,000 per person for capital gain on the sale of your home.

There is also an exclusion for family-owned businesses and farms if the assets are given to an heir who keeps running it. Generally, tax payments on the appreciation of family-owned businesses and farms would not be due until the inheritor sells the business or the business stops being family-owned and operated.

However, note that the definition of qualified small-business stock would be very limited and is applicable only for "C" Corporations. That definition alone will exclude most family businesses, which are typically formed as "S" Corporations to avoid double taxation of corporate and individual income.

While this all may seem generous, if a family business is sold after a lifetime of work (20, 30, 40, 50 years) and the income in that year exceeds the $1 million threshold, then this gain may be taxed as ordinary income. This result leaves little to the family business owner after a lifetime of work, risk and challenges.

In the event that the "step-up" in income tax basis is lost, two alternatives could be imposed. The most draconian would be to tax unrealized appreciation at death. This is the approach used in Canada. Tax is owed without sale proceeds to pay the tax. This approach would require the forced sale of family businesses to pay the tax. The other alternative would require the tax to be paid if and when the business is actually sold. That approach

would be more consistent with how such transactions would be treated in the United States.

Proposed: Loss of the 199A Deduction for Pass Through Entities

Most family businesses operate as Pass Through Entities. Examples of Pass Through Entities include Limited Liability Companies (if electing to be taxed as a Partnership or as an S-Corporation), Partnerships, S-Corporations and Limited Partnerships. Pass Through Entities are not subjected to two separate levels of tax. For example, a "C" corporation pays tax on the net income earned. When that income is paid to its shareholders, the shareholders are taxed on that income as received. The combined corporate and individual income tax rates at the federal and state levels is often significantly higher than 50%.

With a Pass Through Entity, currently there is no tax at the company or corporate level. The House W&M Committee proposal seeks to cap the 199A deduction for individual taxpayers at $500,000 for those filing a joint (married) return, $400,000 for single taxpayers and to only $10,000 for trusts. In addition to a higher tax burden, this could significantly affect the succession planning for family businesses.

Proposed: Changes in the Federal Estate Tax Exemption

Similar changes for the estate and gift tax rates and related exemption may also be on the horizon. Reductions in the estate tax exemption could affect family business owners more dramatically than other groups. Existing laws provide a lifetime **estate and gift tax exemption of $11.7 million**. That means a married couple can transfer tax-free assets with a value of $23.4 million to their children.

The House W&M Committee proposes to reduce the federal estate tax exemption to $5 million (adjusted for inflation to $6.2 million). This parallels what current law provides. The only difference is that it would take effect on Jan. 1, 2022, which is much sooner than the Jan. 1, 2026, effective date that was set by the Tax Cuts and Jobs Act. This means that a married couple could transfer assets with a value just over $12 million to their children or loved ones without incurring an estate tax liability.

Legislation proposed by Sen. Sanders, meanwhile, seeks to further **reduce that exemption to $3.5 million** for individuals.

Proposed: Changes to Various Trust Possibilities

Many tools traditionally used to reduce estate tax may be legislatively taken away. Tools or techniques at risk include short-term Grantor Retainer Annuity Trusts (GRATs), sales to Intentionally Defective Grantor Trusts (IDGTs) and even the use of discounts for estate tax purposes. The loss of discounts may have the greatest impact to family business owners.

If you have a family business worth $30 million and you transfer 50% interest to your children, then you would think that the remaining interest would be worth $15 million. However, a buyer would never pay the full $15 million value because the buyer would not have control over the business. That interest may qualify for discounts between 25% and 49% for lack of marketability and lack of control.

The House W&M Committee legislation would strip away the use of valuation discounts for non-business assets. For example, if marketable securities are held in a Family Limited Partnership to fund business operations, those securities would not qualify for a discount for valuation purposes. This actually is often the position now for IRS auditors for liquid assets such as marketable securities. The proposed change would broaden the categories of excluded assets to include illiquid nonbusiness assets. Many planners were concerned that the use of such discounts might be denied for business assets as well.

With the potential for ongoing law changes, the key term for family business owners seeking to limit their tax liabilities by using trusts will be "access." We do not want to tie assets up in an irrevocable trust in order to avoid potential estate tax later, and then, due to changes in needs or financial position, not have the ability for the family to access those funds.

Already Implemented: Loss of the Parent-Child Exclusion for Property Tax in California

In California Proposition 19, which became effective Feb. 15, 2021, virtually eliminated the parent-child exclusion for property tax purposes for the family business owner. Prior law permitted transfer of the family residence (without any value limitation) from a parent to his or her child without any reassessment of value or increase in property tax. Prior law also permitted the first $1 million of historic base year value of the other real property to be transferred from a parent to his or her child without a property tax increase. After Feb. 15, 2021, the only available parent-child exclusion is for the family's principal residence, limited to the base year value plus $1 million, but only if the child lives in the property as his or her sole residence. This requirement

virtually eliminates the application of the parent-child exclusion for a family business property. As a result, without careful planning, property tax will be increased and taxed to each successive generation at a rate based upon the then current fair market value.

I grew up on a ranch in the East Bay area of California. The ranch has been in our family for over 40 years. If the property was reassessed upon my parents' death, we would not have been able to afford the high property tax.

A Look at What Family Business Owners Can Do

What can you, as a business owner, do to deal with all these changes? Plan, plan, plan. The proposed changes underscore the need for careful planning with all members of your team. Your attorney, tax professional and financial adviser each has a different perspective and different contribution to your long-term survival and success. Here are some ideas to consider.

1. **Think Long-Range When Contemplating a Sale of Your Business**

Planning for the sale of a business should happen well before the desired sale date. First, planning is needed to position the company to receive the highest possible value at sale. A team should be established to review how a buyer would value that business, and then the current operations should be adjusted to enhance that value.

2. **Income Tax Planning**

Some family businesses will be affected more than others with these income tax changes, including the potential loss of the step up in basis, coupled with the changes to property tax (and for those in California the virtual loss of the parent-child exclusion for property tax). These changes may have a greater effect on the farming and agricultural (AG) businesses.

AG businesses are dependent on land ownership and are often designed for multiple generations. We already lost many retirement planning opportunities with the Secure Act, which took away the ability to stretch and defer tax on retirement benefits for multiple generations. Many of the proposed tax changes are triggered if income of a stated amount is reported, such as $450,000 for high-income taxpayers or $1 million for higher capital gains tax. The elimination of stretch IRAs will make it more likely for the business owner to be subject to those higher taxes, causing a cascading effect. In addition, a **proposal under the Biden administration** would restrict the ability to exchange real property on a tax-free basis under IRC Section 1031 for amounts

over $500,000. These restrictions could be problematic for the family business owner, particularly AG businesses, tied to the land.

But there are ways to help blunt those tax effects. Certain tax-advantaged devices or tools, many that we have used for years, will become more effective with higher tax rates and changes. Many of these tools will be used differently or in combination with other techniques. These tools are often broken into charitable and non-charitable techniques:

- Traditional charitable tools include charitable lead annuity trusts (CLATs), charitable remainder trusts (CRTs) and pooled income funds (PIF).
- Traditional non-charitable tools would include intrafamily installment sales and NING trusts (which stands for Nevada Incomplete-gift Non-Grantor trusts).

3. **Lesser-Known Tax Strategies to Consider**

Enhanced Installment Sale

For AG or farm businesses, an enhanced installment sale permits the client to defer capital gains for 30 years. This approach can provide approximately 93% of the sale price in cash to the seller without the need to invest in like-kind property. This strategy while effective for AG and farm businesses, is generally not appropriate at this time for other types of businesses.

Two-Year Installment Sale

This type of installment sale allows all or a portion of the business to be sold to a trust for the kids/grandkids at least two years and one day prior to the sale to an unrelated party. Then, when the cash sale is made, that portion of the capital gain can be effectively deferred for 30 years.

Basis Shifting

The partnership basis allocation rules in the Internal Revenue Code provide a unique opportunity to avoid capital gains of the sale of an appreciated asset. This solution may be appropriate for the sale of an appreciated asset with a low-income tax basis purchased by or contributed to a Limited Liability Company or a partnership more than seven years ago. This method is for assets being sold that have been held by the partnership for at least seven years. This strategy is effective without regard to whether the business was inherited. The key is to distribute a high-basis asset to the partners prior to the sale coupled with an election under IRC Section 754 seeking adjustment

under IRC Section 734(b). The high-basis asset may even be acquired. With that election, the high basis of the asset distributed is allocated between the asset distributed and the low-basis asset to be sold. Essentially 50% of the gain otherwise taxed can be insulated from tax.

A Custom-Defined Benefit Plan

A defined benefit plan can be custom designed and built. People all too often think that all plans or techniques with a common name will provide the same benefit. Depending on the circumstances, a specialist may be able to design a plan with large deductible contributions that far exceed typical retirement plan contribution limitations. This may offer a tremendous way to accumulate wealth.

(Free) No-Cost Life Insurance

For a client with a net worth in excess of $10 million, he or she may have the ability to obtain millions of dollars in life insurance with no out-of-pocket cost. The cost of the insurance is entirely paid by the issuance of an investment grade bonds. The client posts collateral, but would have no out-of-pocket cost whatsoever. The insurance would build a cash value over time. That cash value can provide substantial after-tax (tax-free) streams of income in later years as well as provide future benefits to family in addition to the death benefit. This can be used for estate planning or business succession purposes.

Qualified Opportunity Zone

Qualified Opportunity Zone investments ("QOZ") can be used to avoid or even eliminate capital gains tax. Many believe that QOZ investments must be tied to a professional manager, which results in losing control over your funds and investments. We successfully created LLCs for QOZ funds to be managed for by our clients, so they retain complete control over all investments and funds. For these clients, they maintain complete control and their funds and investments are not mixed with the investments for other persons.

Qualified Small Business Stock

IRC Section 1202 – Qualified Small Business Stock is exempt from federal capital gains up to $10 million or 10 times the aggregate basis. Many advisers are unaware of this benefit and fail to determine if the shares qualify or consider that in the sale negotiations.

Charitable Lead Annuity Trust (CLAT)

In the charitable arena, a Charitable Lead Annuity Trust (CLAT) can be designed to generate a charitable income tax deduction equal to 100% of the contribution. The CLAT makes annual distributions to charity for a defined term, typically around 15 years. At the end of the term, the assets in the trust are returned to the client or pass to the client's family. The client chooses which charity or charities receive the annual distributions, and the client can maintain control over the assets during the term. The client can retain control over the investment throughout the entire trust term.

Pooled Income Fund

A pooled income fund is another often overlooked charitable tool that can provide the appropriate client a greater income tax deduction than a **charitable remainder trust**. The client retains all income for life (or on a multi-generational approach the client and his or her spouse and their kids). The client would be able to retain control of the investments throughout the pooled income period.

What All This Means for the Next Generation of Family Business Owners

There are many challenges to the success and even continued viability of the family business in the years to come.

First, a recognition that for many the family business is a lifestyle. While the loss of the step up in basis or a higher capital gains tax rate would be a significant challenge, there are many more challenges with equal or perhaps greater impact. The real issue is the synergistic effect of all of these coming together. This is happening now when the greatest transfer of wealth between generations is in its infancy. Baby boomers are expected to **transfer $30 trillion of wealth** to younger generations in the next few years.

All of this underscores the need for flexibility in both your income, tax planning and your family estate plan. Financial planning for business owners will become increasing complex. This type of planning should be team-based, multidisciplinary, including the lawyer, tax professional, accounting professional and financial adviser, as each brings an important yet different perspective. Above all, the focus should be on the client's overall business succession planning and not simply lower tax.

Conclusion: Even though the tax environment seems to be less favorable, there are still many opportunities available. But now it requires more initiative for clients to seek competent counsel and to get out in front of their transaction deadlines.

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