

Business Succession Opportunities after Tax Reform

Amundsen Davis Corporate Alert
March 2, 2018

Business owners have long struggled with transferring ownership of closely held businesses to younger generations. Intergenerational transfers are challenging. Only 10% of businesses survive the 3rd generation. Commentators attribute some of the difficulty to family dynamics and the inherent differences in generational expectations. While the family component may often be the most significant factor, business owners also need to focus on the tax costs of transferring their interests. ALL transfers have tax consequences and should be addressed so the business is not cannibalized. This alert focuses on lifetime transfer opportunities created by the Tax Cuts and Jobs Act of 2017 ("2017 Tax Act").

For tax years beginning after 2017 and before 2026, the 2017 Tax Act doubles the estate and gift tax applicable exclusion amount from \$5 million to \$10 million, which continues to be indexed for inflation. For 2018, a single person can gift assets worth up to a lifetime limit of \$11.2 million (or \$22.4 million for a married couple) free of gift tax and thereby decrease the value of his or her estate to be subject to estate tax at death. After January 1, 2026, the exclusion amount reverts back to 2017 levels (\$5.49 million adjusted for inflation) absent further legislative action.

The temporary increase in the exclusion amount creates an opportunity for business owners to gift a greater value of company interests to successive generations without incurring tax. Current gifts will utilize the increased exclusion amount before the exclusion reverts back to 2017 levels. Increasing gifts is preferable to dying during this window, and the resulting decrease in the value of the estate will continue after 2026. Failure to take advantage of this unique opportunity will create a "should of, could of, would of" scenario when faced with an increased gift and/or estate tax liability on assets that could have been protected through relatively simple planning.

Example:

A married couple owns 100% of the stock of Company X, which is worth \$22 million. The couple's exit strategy is to transfer their entire interest in the company to their two children. The married couple can recapitalize the company and gift nonvoting shares representing 99% of the economic value of the

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company to their children, while maintaining complete control of the company through the retention of voting shares. For simplicity, ignore minority interest and lack of marketability discounts and other mechanisms to leverage the exclusions. The married couple could gift \$21.78 million (99% of \$22 million) in nonvoting stock to their children gift tax free upon use of most of their exclusion amounts. When the exclusion reverts back to \$10.98 million for a married couple, \$10.8 million will remain shielded from estate and gift tax by use of the increased exclusion before 2026. Furthermore, any appreciation in company stock after the gift will also avoid inclusion in the married couple's estate, as the appreciation will be realized by their children.

By contrast, if no tax planning is done and the company stock appreciates to \$30 million at the time of the death of the second spouse, \$19.02 million (\$30 million less the \$10.98 million exclusion) would be subject to estate tax, which at 40% amounts to \$7.608 million. The children would then have the burden of finding liquid assets to pay this amount. If none are available, the children could be forced to sell the company or a portion of its assets to pay the tax. This avoidable scenario is a common cause of death for family businesses.

In addition to increased exclusion amounts, taxpayers should continue to utilize the annual gift tax exclusion amount, which is \$15,000 per person (\$30,000 for a married couple) per recipient in 2018. Use of the annual gift tax amount preserves the estate and gift tax applicable exclusion amount for later use and planning opportunities. Any amount gifted in excess of the annual gift tax amount requires the filing of a gift tax return to apply all or a portion of the gift tax applicable exclusion amount. Once the gift tax applicable exclusion amount is used (or if it is elected not to be used), tax will be owed.

Once business owners decide to begin the transfer of company interests to the next generations, they should continue to use tried-and-true estate planning techniques to leverage exclusion amounts and valuation discounts, including sales to intentionally defective trusts as well as use of family limited partnerships, gift trusts and generation skipping trusts. Any one or more of these strategies will aid in the successful transition of business ownership, depending on the goals of the company and the desired ownership mix. It is important to keep all owners and family members involved through all phases of succession planning. Good communication and planning will help ensure a successful transition and the benefits of company ownership for generations to come.