Family Business Succession Planning in the Era of Tax Uncertainty: Use Available Tax Advantages or *Perhaps* Lose Them

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With the Presidential and Congressional elections less than two weeks away, there has been much speculation regarding potential tax law changes that may follow. While pundits assume these “proposals” are clearly defined, many details necessary to enable careful tax planning are missing. This briefing will review the high-level concepts being discussed but makes no promises as to which may come to fruition.

Uncertainty results from several factors. First, a Joe Biden presidency with continued Republican control of the Senate, would substantially mitigate the potential for tax increases. Second, it is unclear when new legislation may be passed and, more importantly, be made effective. On a bottom-line basis, it will take some time for a new Congress and President to enact legislation which requires cooperation between the executive and legislative branches of government. Recent (in)action in Washington, D.C. evidences how rare such cooperation may be. Although there is some limited possibility that any tax law changes could be made retroactive to January 1, 2021, even if passed later in the calendar year, long periods of retroactivity could lead to constitutional litigation, as well as practical issues regarding IRS enforcement.

Subject to the above qualifications, below are three of the more impactful changes being discussed that should concern high net worth individuals and business owners seeking to preserve or transfer wealth for succeeding generations.

Taxation of Gains on Sale of Capital Assets (including your family business)

Under current law, capital gains are generally taxed at preferred (lower) rates of tax if resulting from the sale of a capital asset that is held for more than one year. These rates currently range from zero to 20%. While an additional 3.8% tax on investment income can be imposed on taxpayers whose adjusted gross income is more than $200,000 ($250,000 for married couples), the maximum combined federal rate is less than 24%.[1]

Included in proposed funding for a health care plan announced by candidate Biden, is an increase in the top marginal rate of tax for long-term capital gains to 39.6%. This rate results from two proposed law changes. The first would eliminate the reduction in the top rate of tax applicable to ordinary income that occurred under 2017 tax legislation. The second would tax capital gains at ordinary rates of tax for taxpayers with more than $1,000,000 of taxable income. It is unknown whether the 3.8% net investment income tax (NIIT) would remain. As this is a key funding source under the Affordable Care Act, the NIIT tax could remain. If it does, the rate at which capital gains could potentially be taxed would exceed those imposed on wage income.

While changes in capital gain taxation will anyone holding capital assets, these changes are particularly important in the assessment of family business succession planning. Structured sales of interests in such businesses are often part of the overall planning occurring within families. The analysis regarding (a) sale to junior generations versus (b) gifting to or inheritance of assets by junior generations changes significantly for both the current owner and their intended successors. Business owners contemplating a sale to junior family members in the near term, may wish to consider accelerating such sales to take advantage of both lower rates of taxation and potentially lower valuations due to COVID 19 uncertainties if there is a desire to transfer at a suppressed price. Of course, any such acceleration will also accelerate the timing of tax liability, particularly if installment sale treatment is avoided to capture 2020 tax rates. Installment sale treatment generally allows sellers to recognize taxable gain over the time period during which installment payments from the sale are received instead of entirely at the time of sale closing. While often attractive due to the time value associated with deferral of capital gain recognition, a significant increase in capital gain rates may change this equation, particularly for sales with short-term payment streams. All sellers of businesses in 2020, will want to carefully consider whether to make an election out of installment sale treatment to cause all gain to be taxed at 2020 tax rates. This election must be made by the due date for filing the tax return for the taxable year in which the underlying sale occurs.

Taxation of Unrealized Gains on Assets Passing to Your Heirs at Death

Under current law, assets that are inherited receive a so-called “step-up in basis” pursuant to which the recipient is treated as having purchased the inherited asset at the full fair market value at the time of the decedent’s death.[2] The present step-up in basis at death occurs even if the size of an individual’s estate is not large enough to trigger imposition of estate tax. This basis step-up enables persons inheriting assets to avoid payment of capital gains tax on the increase in value occurring since the decedent acquired the asset through date of death, and to effectively “re-charge” an asset with a basis that has been reduced as a result of depreciation deductions (particularly important to real estate investors).

The Biden proposal would eliminate basis step-up at least to some extent. It is not clear if this would (a) simply result in a continuing of low basis (carryover basis) until the asset is eventually sold, at which time capital gain tax would be payable, or (b) there would be a tax assessed at death on the phantom gain computed as though the asset had been sold at fair market value at the time of the transferor's death, or (c) some other system that would take a more phased approach that would allow basis step-up to a limited extent as was present for a short period of time in past tax years. Potential elimination of basis step-up removes one of the incentives for business owners to hold assets until death when their heirs would receive a step-up in basis that would otherwise not occur if lifetime gifting were used as a method of ownership transfer.

Modification of Current Estate and Gift Tax Exclusion Amounts

The Internal Revenue Code imposes taxes on transfers made by individuals during their lifetime (gifts) and at death (inheritances) when the total value of all of such transfers exceeds a particular amount. The amount above which taxation occurs (the "exclusion amount") has varied through the years. At present, the exclusion amount is $11.58 million, which is its largest level since creation of the estate tax. The current exclusion amount results from legislation passed in 2017, which doubled the basic exclusion amount from $5 million to $10 million (before inflation adjustment [3]) for tax years after December 31, 2017, and before January 1, 2026. On January 1, 2026, the basic exclusion amount is scheduled to revert to $5 million, as adjusted for inflation.
Because the doubling of the estate and gift tax exclusion amount expires for decedents dying and gifts made after December 31, 2025, estate planners have viewed the next several years as presenting an opportunity for wealthy individuals to make large gifts that would reduce the eventual tax burden for clients dying after 2025. However, the present political environment and the stated Biden platforms have raised the specter that the estate and gift tax exclusion amount could be cut in half, or reduced even further, by legislation in 2021.

As a result, many clients are accelerating their gifting programs to take advantage of the larger exclusion that exists today. This acceleration of gifts can result in estate tax savings in excess of $2.3 million at current estate tax rates, for those persons who would otherwise make transfers by gift or inheritance after a 50% reduction in the exclusion amount. The savings could potentially be even larger if certain proposals to reduce the estate tax exclusion to the $3 million level are pursued.

The above is by no means a comprehensive discussion of potential tax law changes, merely those that have the largest potential impact on transfer of closely held business interests within families where there may be a logical combination of sale, gift, or inheritance transfers in play. Because there is no certainty as to whether any or all of the above potential changes will occur, individuals are encouraged to review their personal situations with their personal advisors to determine what steps, if any, should be taken in the near term. This discussion can focus upon the interplay of the proposed changes and risks associated with the potential that some, but not all may come to pass. For example, do large gifts in 2020 make sense given the loss in step-up in basis at death that is available under present law? While the advice in this regard would be clear if one knew the substance of any 2021 tax law changes that will occur, we cannot provide the required crystal ball that will confirm the answer. Instead, we can only recommend that you discuss the above potential changes with a seasoned advisor to determine if you wish to take steps now to avoid potential loss of available tax advantages present under the current law. This is truly a situation of use it or ***perhaps*** lose it.

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[1] A discussion regarding various tax benefit recapture rules applicable to certain assets is beyond the scope of this article.

[2] In contrast, the recipient of a lifetime gift simply steps into the shoes of the gift maker and assumes his basis.

[3] The $11.58 million figure is the result of the application of the inflation adjustment to the $10 million basic exclusion amount. The IRS recently announced this amount would increase to $11.70 million in 2021 if Congress does not act to affirmatively reduce the exclusion set forth in the current Internal Revenue Code.