

# ALERT - Business Succession Planning Opportunities Under the New Tax Act

Late last year, President Trump signed into law the Tax Cuts and Jobs Act of 2017 (the “Act”), effective in 2018 for tax purposes.<sup>i</sup> The Act provided certain substantial changes to the tax code that include provisions that may be of interest to family owned businesses and professionals. This article will address the changes to the estate tax system, the new deduction for qualified business income of pass-through entities and how planning for one or both may be beneficial for succession planning needs.

## Applicable provisions of the Act

One of the main changes the Act made was effectively doubling the unified federal estate and gift exemption (the “Exemption”). Under the old law, an individual’s Exemption was set at a base of \$5 million indexed to inflation.<sup>ii</sup> As of 2017, the individual Exemption was \$5.49 million.<sup>iii</sup> Under the Act, an individual’s Exemption base is doubled to \$10 million, and after accounting for inflation, the individual Exemption is estimated to be near \$11.2 million for 2018.<sup>iv</sup> The Act retains inflation indexing for the Exemption. Therefore, as a result, you can expect the Exemption to increase each year. Also, the generation-skipping transfer tax (“GST”) exemption is still tied to the Exemption under the Act; therefore, the individual GST exemption is also \$11.2 million per individual.<sup>v</sup>

Importantly, the Act did not change the availability of portability of Exemption between spouses; therefore, a married couple has effectively \$22.4 million of Exemption to utilize in their estate planning.<sup>vi</sup> Furthermore, the Act

did not make changes to the annual gift tax exclusion. For 2018, the annual gift tax exclusion is \$15,000 of property annually to any donee without using any of the individual’s Exemption.<sup>vii</sup>

However, the Act is set to expire in 2025, due to certain Senate budgetary rules. After its expiration, the Exemption and GST exemption limits will revert to pre-2018 levels.<sup>viii</sup> Therefore, absent Congress making the provisions permanent, individuals or families looking to take advantage of the increased exemption limits may need to act sooner rather than later to utilize their Exemption for succession purposes.

## Are C Corporations and certain pass-through entities favored under the Act?

The Act dramatically lowered the corporate income tax rate. Starting in 2018, C Corporations will pay a flat rate of 21%, which is significantly lower than the previous 35%.<sup>ix</sup> Additionally, the corporate alternative minimum tax is fully repealed.<sup>x</sup>

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”).<sup>xi</sup> QBI is defined as net business income after all business deductions have been claimed. However, due to particular limitations, only certain pass-through entities will be able to utilize this deduction. First, there are threshold income limits: \$157,500 for single filers and \$315,000 for married joint filers; and phaseout

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limits: up to \$207,000 for single; and up to \$415,000 for married joint filers. For taxpayers under these limits, the deduction is available to all. For taxpayers above the threshold limits, there are limitations in place to reduce or eliminate the deduction.<sup>xii</sup>

In addition to the threshold limits, certain professions are excluded from utilizing the deduction if the professional taxpayer's income is above the phaseout limits. Excluded professions are those in the professional service industries of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.<sup>xiii</sup>

If the deduction is available for taxpayers above the phaseout limits (and those not in the excluded professions), then the deduction is limited to the lesser of: (1) 20% of QBI or the greater of either (i) 50% of the W-2 wages of the business or (ii) the sum of 25% of W-2 wages plus 2.5% of the unadjusted basis of all "qualified property" in the business.<sup>xiv</sup> For the purposes of this provision, qualified property is defined as any tangible property for which depreciation deductions are allowed under IRC Section 167, that was held by and used in the business, and has not already reached the end of the depreciable period.<sup>xv</sup> This could potentially include anything from machinery, equipment and real estate holdings, so long as they are still being depreciated. Most practitioners expect that real estate holding companies, organized as pass-through entities such as limited liability companies, may be the

most common businesses to utilize the deduction.

Of note, the Internal Revenue Service ("IRS") has not issued regulations pertaining to the deduction. The IRS stated they hope to issue by the end of June. Also due to complexity of the requirements and limitations, taxpayers should consult their tax attorney, CPA or accountant for guidance.

#### What is the excluded professional to do?

Unfortunately, the Act excludes many professions from utilizing the pass-through deduction above the threshold and phaseout income limits. However, certain opportunities may still exist. Professionals who also 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 family businesses that are not service-related industries, the professional may wish to increase income opportunities through the family business and take advantage of the deduction.

Another opportunity may exist in converting businesses to C Corporations. With the lower corporate income tax, 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.

Finally, there exists great potential to combine the increased Exemption with either the lower corporate tax rate or the pass-

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through deduction. Family operated businesses may wish to utilize lifetime gifts of business interests to younger generations to leverage the Exemption while also potentially reorganizing the business entity structure to utilize the lower corporate rate or the pass-through deduction.

This combination may maximize the power of inter-generational tax planning and current income tax planning while securing the succession of family businesses within the family.

### Conclusion

The Act provides an exciting opportunity for certain types of investments or businesses to lower income taxes while also providing leverage for generational planning. Family businesses should take advantage of this opportunity to secure a wealth and business succession plan while maximizing the available income tax reductions and before certain provisions of the Act expire or are changed by Congress.

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<sup>i</sup> The “Tax Cuts and Jobs Act of 2017” was renamed “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018” on December 19, 2017; Pub. L. 115-97 (hereinafter cited to as the “Act”).

<sup>ii</sup> IRC § 2010 (c)(3); The index used for inflation calculations has been changed to The Chained Consumer Price Index for All Urban Consumers.

<sup>iii</sup> Rev. Proc. 2016-55.

<sup>iv</sup> IRC § 2010 (c)(3); Act § 11061.

<sup>v</sup> *id.*

<sup>vi</sup> IRC § 2010.

<sup>vii</sup> Rev. Proc. 2017-58.

<sup>viii</sup> Act § 11061.

<sup>ix</sup> Act § 13001.

<sup>x</sup> Act § 12001.

<sup>xi</sup> Act § 11011; IRC § 199A.

<sup>xii</sup> *ibid.*

<sup>xiii</sup> *ibid.*

<sup>xiv</sup> *ibid.*

<sup>xv</sup> IRC § 167; Act § 11011.