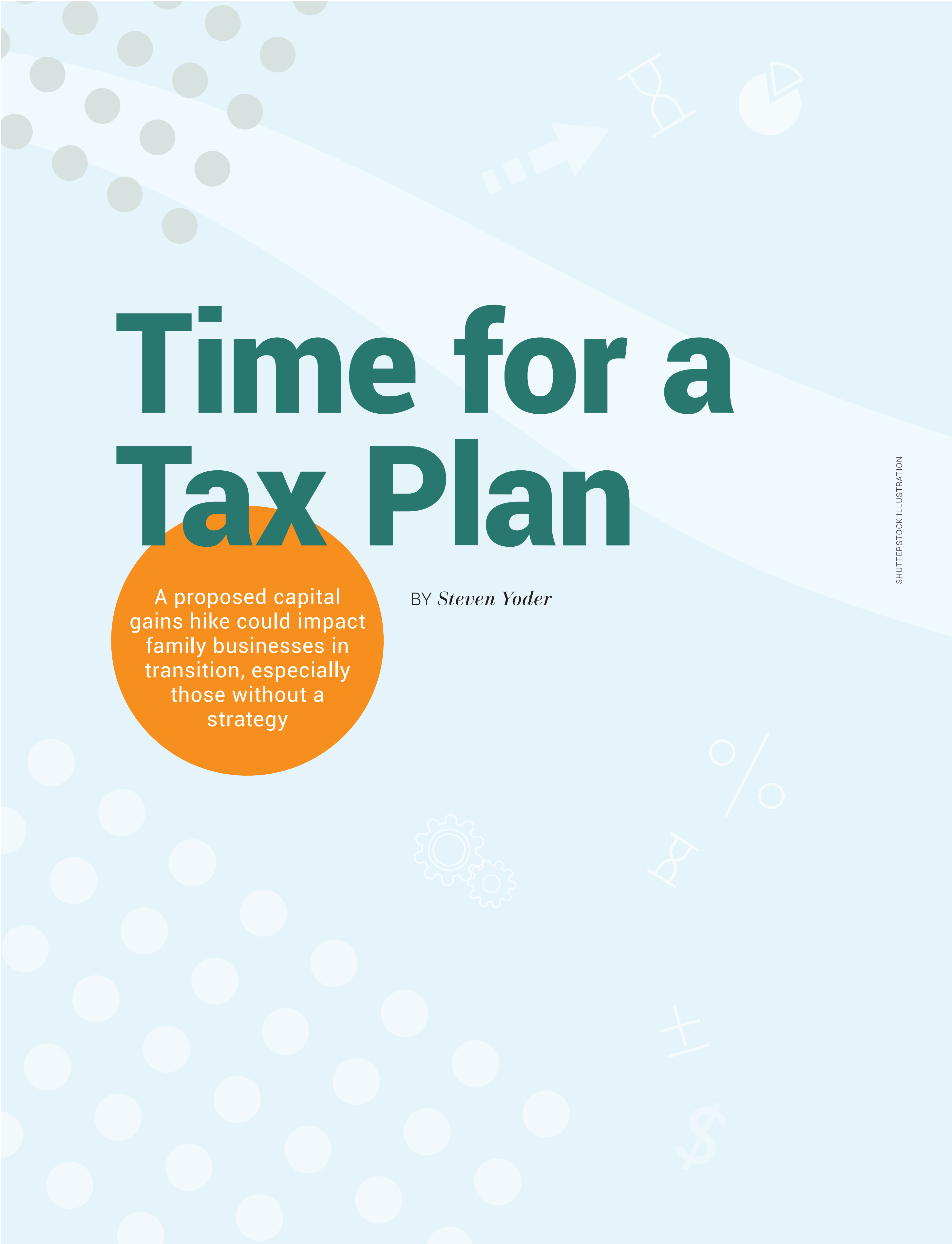

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# Time for a Tax Plan

A proposed capital gains hike could impact family businesses in transition, especially those without a strategy

BY *Steven Yoder*

Every industry's demands are unique, but those in farming grow in clusters. Ken Oneto is the second-generation president of family farm KLM Ranches, based in Elk Grove. They raise cherries, walnuts, wine grapes, cherry tomatoes and more on about 2,000 acres.

Two years ago, they lost half their cherry crop in heavy spring rains. Lower labor rates abroad mean cheaper foreign imports are rolling in that are tough to compete with on price. The supply chain is out of whack — for starters, the labels that go on their cherry boxes are on a 6-month back order. And always, water woes and new state regulations mean they're paying an extra $10 an acre to make sure their groundwater isn't sinking, costs they can't pass on because of the price competition. In farming, margins are usually 2 or 3 percent. "Or you make nothing or you lose," Oneto says. "It's not for the faint of heart."

In late July of this year, he learned about another looming storm cloud: a dramatic change in the capital gains tax proposed by the Biden administration that could take effect next year — or even be retroactive to 2021.

Two provisions of the proposal stand out. Individuals with an adjusted gross income of more than $1 million would see their long-term capital gains rate nearly double, rising from the current 20 percent to 39.6 — the idea being to equalize the capital gains and ordinary income tax rates. It also would eliminate the "step-up" in cost basis that lets an appreciated asset pass to children without their having to pay capital gains on the increase in value.

Lots of family firms could be affected. Because a one-time sale of an asset could generate $1 million in income for that year only, a million households nationwide eventually could be hit with the 39.6 rate, estimates tax attorney and former state tax auditor John Goralka of the Sacramento-based Goralka Law Firm. A June 2021 analysis out of Texas A&M University concluded that eliminating the step-up basis under a proposal similar to that in the Biden plan would target 92 of 94 representative farms in the study, with an average additional tax liability of more than $700,000.

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It's not clear if family businesses thinking of selling should scramble to get it done this year in advance of the changes — it may already be too late if the proposal is passed with the provision making it retroactive to the date of announcement. And avoiding taxes shouldn't be the sole driver of decisions about selling and succession, say tax professionals. But the most important lesson to glean involves the longer term: Family firms should always be ready with a plan for what happens when their business is sold or transferred. A tax strategy keeps you prepared no matter what happens in Washington, D.C., say family business proponents.

## Why the tax collector wins

Tax experts say it doesn't take much imagination to see how a family-owned enterprise could lose control of what they've built, especially under the current proposal. Say a parent owns a $10 million family business. At the time of the parent's death, the next-generation owner would owe $3.9 million in taxes but might not have the required cash. Borrowing it would weaken the business' balance sheet and thus the value of the business, says Elizabeth Leet Jackson, a partner at Delfino Madden in Sacramento. "So it creates opportunity for big corporations to buy the small family businesses at a lower price," she says. Two clients planning to sell told her their deals wouldn't work under the proposed 40-percent rate.

Another adviser has watched sales like that up close. "I've seen this happen more than once with fairly small family businesses, especially if they own capital assets like land and buildings," says Brent Morrison, founder and principal at Chico-based business consulting firm Morrison. "(Taxes) often force sales to larger organizations."

Between the proposed federal rise and California's 13 percent tax on ordinary income, more than half of any sale could go for taxes, says Dave Lucchetti, executive chairman of the board at Rancho Cordova-based Pacific Coast Building Products, which is on its third generation of family owners.

If area family farms end up selling, Oneto says the effects could be felt beyond those involved. "The only people buying ag ground are pension funds and insurance companies looking for investments," he says. With returns low in farming, investors will eventually re-sell the land, likely taking it out of farming altogether, he says — though state law and local zoning can prevent or complicate farmland sales. If they do, "that puts a big dent in your food security," he adds.

Plenty of investors are out there looking for small businesses to snap up, says Edward Cotney, founder and principal at Sacramento-based Olympus Tax, Business and Insurance Solutions. Private equity companies and investment banks — where high-dollar investors put their money to get better returns — were stymied during the pandemic because of the uncertainty, he says. Now they're back. "It's the perfect storm," he says. It's been his busiest year ever for sales of businesses and real estate. Nationally, sales involving purchases by private-equity firms were up more than 20 percent in the first five months of 2021 compared with the same period in 2020, according to professional services giant PwC.

Without a good plan, most family businesses won't be prepared for the next tax hike, even if this one gets killed in negotiations. "Most business owners don't even have the fundamentals in place — let alone an advanced tax structure — to exit their business on the terms that they want to," says Cotney. "So the tax man wins. Overwhelmingly the tax man wins."

## Many strategies, not enough time

It's likely too late to plan a sale to avoid the proposed increase if it becomes law. But the longer-term lesson is that with enough time, you can almost always do something to mitigate capital gains, says Cotney.

Specific strategies abound. Jackson says a family-owned corporate entity that's selling to a third party could do an installment sale. The buyer could make payments over, say, a five-year period of less than $1 million each so the seller stays under the proposal's cutoff.

Companies with many employees could sell the business to their staff through an employee stock ownership plan. Owners who sell to an ESOP can defer or avoid paying capital gains taxes on the sale if they reinvest in U.S. corporate stocks and bonds within 12 months and meet a few other conditions.

Another option is a "Delaware Statutory Trust," says Nathan Torinus, CEO and financial adviser at Van Hulzen Financial Advisors in El Dorado Hills. These let a seller who's realized a big gain roll over the increase into shares in institutional-quality commercial properties like office complexes and apartment buildings.

And Goralka mentions a relatively new option — taking the proceeds of a sale and investing in "qualified opportunity zones." The 2017 Tax Cuts and Jobs Act created these, which are designated low-income communities. To defer a gain, you have 180 days from the date of the sale of appreciated property to invest it into a QOZ fund — one either already established or that you set up. In most cases, any taxable gain is deferred until you sell your interest in the fund or Dec. 31, 2026, whichever comes first.

That's far from the universe of options: Goralka rolls off an alphabet soup of other tax planning vehicles: CLATs, CRTs, PIFs, NING Trusts and more.

Each has its downsides. An ESOP sale, for example, usually brings a lower selling price than one on the open market, says Jackson. A Delaware Statutory Trust is less liquid than many other types of assets. Installment sales defer taxes but also sale proceeds.

There's another option too: Wait it out. Since 1966, the top capital gains rate has changed every few years, ranging from a high of 40 percent in 1976 to a low of 15 percent in 2012. Some of Jackson's clients have told her they may just hold tight until there's a change in administration. Plus, in deciding whether to sell, capital gains taxes should be "a factor but not the determining factor," she says.

And Torinus points out that a proposal is just that. Nearly every new

administration has a tax plan, but the likelihood it will take effect exactly as spelled out is low, he says. "I don't want to send the message that 'Don't worry about these Biden taxes,'" he says. "The message is 'Pay attention to what's going on in the House and Senate and talk to your adviser and CPA as appropriate.'"

The history of the all-important step-up provision in the current plan makes the point. It was completely eliminated in the 1976 Tax Reform Act but created such a nightmare of paperwork that its implementation was delayed and ultimately repealed four years later.

## Create a business tax plan

Even if the Biden plan doesn't survive, family business proponents say one lesson should: Investing in tax planning isn't optional. "When you look at the really successful families, the big family businesses, they know this," says Peter Johnson, director of the University of the Pacific's Institute for Family Business. "What I'm hoping will come out of this is a more sophisticated view from the average family business owner where they say … OK, at the end of the day, we want to pay as little as possible to the government, and let's put together a plan to make that happen."

That requires a multidisciplinary team: a lawyer, tax professional, accounting professional and financial adviser, says Goralka. "Above all, the focus should be on the client's overall business succession planning and not simply lower tax," he says. Part of the reason businesses don't invest in devising one is expense. "It can cost $20,000, $40,000, $80,000 to do this," says Johnson. "But what are you buying? You spend $50,000 and do all this planning and maybe it saves you $2 million in taxes in five years. Is that a good investment? Yes." Families should think of it as an insurance policy they'll definitely use at some point, he says.

These strategies require time to create. "Often people will call me and say, I'm selling my business Tuesday. How do I avoid a tax rise? And that's too late — you need to have the plan in place before the deal is struck," says Goralka.

But having one also means if a tax proposal catches you by surprise, you'll be ready. Though Oneto wasn't tracking the Biden administration's proposal, he thinks KLM Ranches is prepared. As yet, there are no children in the next generation lined up to take over; they all work in non-farming jobs. Could that change? "Right now we don't have a bloodline behind us — maybe — but as of right now, no," Oneto says.

Whatever happens, Oneto's parents did a lot of estate planning, and they're set up as a corporation, with the land held by limited liability companies. So if the tax rules or the family's circumstances change, "we should be all right," Oneto says.

*Steven Yoder writes about business, real estate and criminal justice. His work has appeared in The Fiscal Times, Salon, The American Prospect and elsewhere. Online at www.stevenyoder.net and on Twitter @syodertweet.*

Does your family have a tax strategy in place?

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