JGTRRA and the Family Business

By Greg McCann, CPA, and Paul E. Dascher

THE JOBS AND GROWTH TAX RELIEF RECONciliation Act of 2003 (JGTRRA) has been discussed and examined in both the business and popular press, including this column. Generally missing from that coverage, however, has been a focus on a major segment of the U.S. economy—family businesses. Though defined in a variety of ways, family businesses share certain key characteristics, including a capital investment made or maintained by individuals related by birth or marriage that provides effective control of an organization. Family businesses constitute about 90% of all U.S. firms, and, though they are more likely to be small- or medium-sized companies, they produce half of the nation's GNP, employ half of the workforce, constitute up to a third of the *Fortune* 500, and generate the majority of new jobs.

JGTRRA focuses primarily on stimulating economic growth by encouraging increased spending, increased investment, greater business profitability, and the creation of additional jobs. Its provisions affect individuals and businesses differently. Individuals benefit from tax relief, which adds purchasing power and encourages investment, while businesses benefit from liquidity and encouragement of capital investment. The Act gives both groups incentives to spend and invest.

While many businesses may be examined from the perspectives of the organization or its owners, family businesses have that added dimension—the family. These three groups or systems overlap both in terms of the number of people in more than one group (e.g., one person who is a brother in the family, the CFO in the business, and a minority stockholder) and in terms of influence (e.g., it may only be a few common people in the groups, but they hold key positions). Given this ownership, areas of particular interest are family members with an ownership interest and who work in the business and family members with an ownership interest who don't work in the business. Thus, people who are a part of two or three of these systems, especially those of business and ownership, have an even greater stake in the consequences of the tax laws.

The aspects of JGTRRA that address capital gains and dividends raise special issues relative to family ownership and family compensation matters that should be considered in plans within family businesses. Ideally, a family business should have a strategic plan and a management development plan for the business (especially related to the next generation of the family in the business), an estate plan and family constitution for the family, and a buy-sell agreement for the stability of the ownership transfer. The changes in the tax law need to be factored in, especially for the strategic plan and the ownership transfer issues.

While tax strategies and future plans will certainly differ by firm, some common questions need to be addressed.

The Act reduces the top capital gain rate from 20% to 15% while simultaneously lowering the top marginal income rate from 38.6% to 35%. Effectively, the advantage of realizing capital gains moves from 18.6% (38.6% – 20%) to 20% (35% – 15%). This difference may be significant and can place owners in a position of seeking to realize gains on appreciated holdings through current sales. Such a financial strategy may have an unintended negative effect on the control of a family-run business through the sales of securities to nonfamily members, or it may provide an opportunity for family control to increase, as offers to nonfamily owners for their shares become more tempting.

Another related area of planning concern is philanthropic giving. Family businesses tend to be community leaders and avid supporters of local, regional, and national charitable causes. Given this proclivity, the change in rate also eliminates the incentive to donate appreciated property. Historically, there has been a tax incentive to transfer appreciated property for philanthropic purposes. The change provides a similar benefit to selling appreciated property and subsequently donating the proceeds. By providing the potential donor with the sale proceeds, an opportunity to reduce or defer charitable giving is added to the decision-making process. This might make the donation phase more problematic.

A section of the JGTRRA that presents a buffer against the capital gains issues is the change in rate for qualified dividends. Essentially, dividends paid on stock held for 60 days or longer will be taxed at a maximum rate of 15% as opposed to previous structures that included these dividends as a part of ordinary income subject to marginal rates as high as 38.6%. This change provides a means for transferring current income within the business to family and other owners without forcing stock sales that would dilute family control. Also, it provides an important estate tool through dividend-yielding preferred stock as a succession vehicle through a preferred recapitalization.

While all organizations should explore each of these areas and all aspects of the JGTRRA in depth, this is particularly important for family businesses to do. There is a balance between appropriate compensation and appropriate return to owners, and there's a need to maintain effective control if the organization is to survive as a family-controlled business. Interactions and relations among family, managers, and other owners remain a constant challenge. The planning opportunities are significant and should be addressed. ■

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