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## The Tax Effects of the Family Business Succession

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### Abstract

Ensure the continuity of the family business requires a solution of the succession question in the leadership or the transfer of the company. The succession issue affects many factors. The paper will be focused on the issue of the tax effects of the family business succession. In 2014, there was a significant change in legislation in the Czech Republic, entered into force the new civil code, which has done a fundamental change in the area of income taxes, inheritance and gift taxes. The main aim of the paper is to identify tax effects of the family business succession, transition of ownership and leadership of family business from the perspective of current legislation. The analysis and comparison methods were used for the purpose of the research. The research findings show a significant impact of the new legislation on the taxation of family business succession.

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*Keywords:* succession, family business, transfer of business, ownership transition, Czech Republic

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### 1. Introduction

The paper deals with the issue of succession in family business. For the entrepreneurs and his family is a transfer of the family business to his successors an important strategic challenge. In each case, the process of family business succession is very specific. The wishes of the business owner and the transfer of family business to his successor (or successors) are not mostly identical. Between the basic factors that make the process difficult belongs the tax effects connected with the different ways of realization of the family business succession. The main attention of the authors is therefore paid to the question of transfer or transition ownership with an emphasis on the tax effects. The question of the transfer ownership begins to be very timely for family businesses in the Czech Republic. Due to the historical development of the Czech Republic, which did not allow private property, the current entrepreneurs stand nowadays before the question how to pass their often already strayed business to the next

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generation. They have to resolve the question of family business succession or to proceed to the sale of their business. The decisions of these entrepreneurs have significant tax effects, which the authors summarize within the paper. In the literary sources, there have not been given sufficient attention to this area of tax effects in the process of family business succession in the Czech Republic and therefore, the authors decided to submit the issue in their research. The main aim of the research was to define the tax effects of the family businesses succession in relation to the current legislation and to help entrepreneurs in solving this issue. A partial aim of the research was to make comparisons with previous legislation.

#### Nomenclature

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|---|--|
| A | The research is focused on family business with the main emphasis on small and medium-sized enterprises. |
| B | The transition of ownership in family business, the issue of succession and its tax effects.             |
| C | The examples of solutions to model situations and formulation of general recommendations.                |

## 2. Material and Methods

The family businesses can be small, medium (SMEs), or large. It is currently very discussed issues how to define the family business. There are a number of definitions of a family business, which evolved gradually over time. In the literature it is possible to find the classification of the owner (a family member) or the extent of involvement of a family member in the business according to several aspects. In the Czech Republic, there is only little researches dealing with situations of family SMEs. The most studies dealing with family business were made in the United States and in the Western Europe. Other authors define the family business more specifically, because the definition expresses the fact that the company is controlled by family members. Davis and Tagiuri (1985) define the family business as a business in which two or more extended family members influence the direction of the business. Beckhard and Dyer (1983) characterize the family business as the system that includes the business, the family, the founder and such linking organizations as the board of directors. Chua et al. (1999, p. 35) state that family firms are defined as *“a business governed and/or managed with the intention to shape and pursue the vision of the business held by a dominant coalition controlled by members of the same family...in a manner that is potentially sustainable across generations of the family”*.

Kalouda, Koráb et al. (1998) use the definition that was created by the Institute for family enterprise in Spain in 1991: *“Family companies are companies with the biggest or at least an important share of capital, which is held in the hands of a few people or companies from the same family, if they are involved in the management and leadership of the company and it does not matter in which economic sector the company operates.”* Strážovská a Strážovská (2002) defines the family business as follows: *“As a family business can be marked the enterprise, which includes several generations and where the factor of family extends to life and operation of the business.”* Lukeš, Nový et al. (2005): *“As a family business we consider a business in which the decisive share own members of one or more families, which manage this company.”* Poutziouris et al. (2006) define the family business as a business run by the founder of a descendent and with the intent of keeping the business in the family. Miller, Le-Breton-Miller et al. (2007) define that *“family business the ones in which more members of the same family are involved as the principal owners or administrators, simultaneously or in the course of time.”* Barnes a Hershon (1976) point to the fact there is something most deeply rooted in transfer of power than impersonal business interests. The human tradition of passing on heritage, possessions, and name from one generation to the next leads both parents and their children to seek continuity in the family business. According to Le-Breton-Miller et al. (2004) succession in family businesses is very complex that multiple perspectives have been used to understand and explain it. These factors can be divided into two related domains, business and human.

The issue of family business succession Schwendinger (2011, p. 34) defines as *“a transition of ownership and leadership from one member of the family to another.”* The author point out to the fact there are different size of family business, ranging from micro-businesses to large companies. Schwendinger (2011) stresses the family members must be satisfied with the process of ownership transfer, and the non family members, employees, must adopt the same stance as well. The main aim of the research was to define the related methodology with an emphasis on the role of non family member (employees) in the family business succession process.

Solomon et al. (2011) made in the framework of its qualitative research study, whose attention was focused on the life-stories of 10 family businesses. The main aim of the interviews was to identify the experience of the owners with the main emphasis on the complexity of the issue of family business succession. The authors identified four key areas, which seem to have the potential to facilitate or constrain the family business owner's approach to succession. The first of these areas is "The business within" – in the sense of to take position on the differentiation and control. The second area is "The marriage" with an emphasis on traditional gender roles in succession. The third area, according to the authors is "The adult children", where authors pay attention to the pose of the so-called a natural (accidental, organic, passively groomed) successor. The fourth area is "The vision of retirement" in the sense of the impact of ideas of the current owner on the company life after the succession.

Gilding et al. (2013) state that the issue of family business succession planning, which is contained in the literature, mostly focused on ensuring the continuity of family business across generations and family harmony. As a key theme in the context of family business in the realized researches are very often discussed the issue of family business succession planning, which is a central theme and that puts particular emphasis on ensuring the continuity of the business. The Authors further point out to the fact that the understanding of the motives in family business succession referred in the literature is often confusing. It oscillates between an economic understanding of motives in term of individualistic utility maximization, and a more sociological approach which takes into account the effects of social upbringing and collective (familiar) interests.

Liu et al. (2015) focused attention on the issue of nepotism in the family business succession process. According to the authors the successions often leads to a decline in performance because leaders frequently choose family members as their successor, a form of nepotism. Authors demonstrate in their research, the phenomenon of the succession, model it and subsequently also test it in the context of the decision-making process related to the issue of family business succession planning.

In order to achieve the above specified objectives of the research are used the method of analysis and the method of comparisons. As reported by Synek (1999) method of comparisons is based on the examination of the same and different pages for two (or more) examined objects or phenomena. The method of comparisons is used in the research for the purpose of comparisons the previous and current legislation with the emphasis on the tax effects in model situations.

### 3. Results and Discussion

Due to the adoption of a new Act No. 89/2012 Coll., the Civil Code (further only NCC), which entered into force from the 1<sup>st</sup> January 2014 is in relation to businesses, first needed to define the used terms. The NCC do not use the term "enterprise", which usually use for example the European Union in relation to the small and medium-sized enterprises (further only SMEs), but it operates with a new term "trade factory". The trade factory is defined in § 502 of the NCC as follows: "*Trade factory (further only "factory") is an organized set of assets, which entrepreneur has created and which has been used for the purpose of his business. It is considered that the factory consist of everything that is usually used for its operation.*" The meaning of the newly defined term "trade factory" essentially corresponds with the definition of "enterprise". The author in accordance with the approach of the European Union decided to use in their research.

A partial aim of the research was to provide a comparison of previous and current legislation in the context of family business succession. It is necessary to mention the connection with the codification of new private law. From the 1<sup>st</sup> of January 2014, there was repealed Act No. 357/1992 Coll., on inheritance tax, gift tax and real estate transfer tax. At the same time were covered inheritance tax and gift tax to the Act No. 586/1992 Coll., on income taxes and with the new legislation changed also the used terminology. Generally used term "gift" was replaced by a new term "gratuitous income". In the case of gratuitous incomes are non-monetary incomes for tax purpose valued: (1) According to the Act No. 151/1997 Coll., on the valuation of assets (the existing regulations governing the valuation of assets); (2) Five times value of annual performance, if income is another property benefit, which the content is repeated the performance at the time: for an indefinite period; about the life of humans or for more than 5 years. All gratuitous incomes received by taxpayers in connection with the performance from employment or entrepreneurship (physical and legal entities) are object of the Income Tax Act. The provisions of law also apply for the gratuitous incomes tax non-residents arising from sources on the territory of the Czech Republic.

The next part of the paper will focus on the gratuitous incomes in a family business. In accordance with the applicable Income Tax Act are arrangements about the gratuitous incomes for natural persons defined in § 3 (object of the income tax of natural person), § 4a (exemption of gratuitous incomes), § 6 (incomes of employment), § 7 (incomes from entrepreneurship), § 10 (other incomes). Income tax exemptions are incomes of natural persons gained inheritance from relatives in the straight line. In the next line are exempted the approved gratuitous incomes from person, with whom the taxpayer lived at least one year prior to the acquisition of the gratuitous incomes. Income tax does not apply taxation of gratuitous incomes of taxpayers (natural persons) that are excluded from the object of this tax or are exempt from this tax.

Received cash and also non-cash gifts, and other non-cash gratuitous incomes taken by the taxpayers in connection with the performance of their entrepreneurship (for example self-employment, other business, copyright etc.) are object of income tax of natural persons. These gratuitous incomes should be considered as incomes from entrepreneurship according to § 7 Income Tax Act and are also object of social and health insurance for the self-employed. In the case that these gratuitous incomes do not fall into the category of tax exemption, there shall be object of a 15% rate according to Income Tax Act. By the taxpayers of income tax of legal persons are gratuitous incomes the object of the Income Tax Act, if they are not explicitly excluded. The gratuitous incomes are the object of income tax of legal person except the public beneficial taxpayer, which are exempt from the tax. The gratuitous incomes taxation is provided in § 19b (exemption of gratuitous incomes by legal persons), § 23 (tax base) and § 29 (entry price of tangible assets) of Income Tax Act. According to § 23 paragraph 3 (c) point 8 Income Tax Act is the result (or the difference between revenue and expenditure) in accordance with paragraph 2 may be reduced by the value of the taxpayer's gratuitous incomes, which was raised by result (or the difference between revenue and expenditure) in accordance with paragraph 3 (a) point 16 of this provision), if this gratuitous income used to achieve, maintain and providing incomes and was not charged in the cost. The model solution of selected situation and its tax effects of gratuitous incomes on income tax in family business include comparison of selected differences between the previous and the current legislation in the case of the donation of the enterprise, the inheritance or the real estate transfer. In the following table no. 1 will be presented the selected scenarios, which are associated with the issue of family business succession, including the tax effect of these situations on the family business, or individual members of the family involved in succession.

Table 1. The model situations of the gratuitous incomes and its tax effect of on the family business and family members.

Model situations	Tax effects
<p>1<sup>st</sup>: A natural person (self-employed person) passes his entrepreneurship to his son.            In 2014, the entrepreneur (natural person) passed his business activities to his son, which is his successor in the business. In that context, he donated by a gratuitous transfer: real estate, machines, store and other business assets to his son, who has continue in his father's business (as a self-employed person).</p> <p>2<sup>nd</sup>: A natural person (self-employed person) ends his business and the son (successor) does not continue in the business.            In 2014, a natural person entrepreneur ended his business activity and in connection with this situation he provided a transfer of real estate, machines, animals, store and other assets from the business to his son, who does not continue in the business activities of the father.</p> <p>3<sup>rd</sup>: A natural person (self-employed person) ends her business and passes the succession to her two daughters. A business woman, a natural person, Mrs. Pilná decided to terminate her business. She made an agreement that her successors in business will become her two daughters. They do not keep the books and for income tax purpose their lead the tax evidence. Businesswoman, Mrs. Pilná, for the purpose of the business provided to her daughters to the beginning of their business an income of gratuitous fulfilment. Isabella received a slightly used van, which Mrs. Pilná has begun to depreciate. Daniela received store of various materials and goods for resale.</p>	<p>The gratuitous incomes obtained by the free transfer of assets for the business is not the object of income tax by the son (successor).</p> <p>In the 2<sup>nd</sup> case because of failure of set conditions – the continuation of business activities – are the incomes obtained by the transfer of assets between related persons in the context of ending business activities the object of income tax of natural person in the tax period, in which this transfer happend. If the taxpayer fails to file a tax claim in due course, can file afterwards. The taxpayer is not in arrears, if he files the additional tax claims and pays the tax no later than the date, on which it is obliged to submit the additional tax return for the tax period.</p> <p>In the 3<sup>rd</sup> case the daughters, Isabella and Daniela, will not be able to invoke the exemption of other gratuitous incomes from a relative in accordance with § 10 paragraph 3 Income Tax Act, because it does not belongs to a residual category called "other incomes", but it is income of § 7 Income Tax Act, in which any exemption of gratuitous incomes is not allowed by the law.*</p>

Source: authors

(Note to the model situation no. 3: \* As daughters do not keep the books, but the tax evidence (or my also apply the so-called “lump expenditure”), while § 7 paragraph 3 and together with § 23 paragraph 3 (a) point 16 of the Income Tax Act, which in these cases, the difference between incomes and expenditures from business activity increase the value of the taxpayer’s incomes about the value of the gratuitous incomes. Daughter Isabella will be able to start the obtained gift, the car, depreciate as newly acquired tangible assets, and it will be from the taxed value specified by an expert, or by a car mart in accordance with the Act No. 151/1997 Coll., on the valuation of the assets, at the date of acquisition. She will not continue in the way of depreciation used by Mrs. Pilná (her mother – the donor). In the case, Isabella would instead of a car got “only” a cash gift provided for the acquisition of a new car (i.e. tangible assets), than would not be a taxable gratuitous income, but such a gift would reduce the entry price of the tangible assets, from which calculate tax depreciation (§ 29 (1) of Income Tax Act). In the case of other daughter, Daniela, applies § 23 paragraph 3 (c) point 8 Income Tax Act, pursuant to which the difference between revenue and expenditure can be reduced by the value of taxpayer’s gratuitous income, which was according to the above provisions taxed, if it is used to achieve, maintain and provide revenue and has not been charged in the cost. Therefore, she will be able to reduce the partial tax base of the business activities about the taxed value of the gift (acquired store and goods) during its sale of goods and use of materials in her business activities (e. g. work on other contracts)

Previous legislation about donation, inheritance and transfer of real estate was modified by the following laws: Act No. 357/1992 Coll., on inheritance tax, gift tax and real estate transfer tax (further only IGRET) distinguishes three basic groups of people, which defines in detail § 11 IGRET. The first group (further only 1<sup>st</sup> group) are relatives in the straight line and married couple. The second group (further only 2<sup>nd</sup> group) are relatives from the indirect line, as siblings, nephews, nieces, uncles and aunts, and further husbands/wives of children (son-in-law and daughter-in-law), children of the spouse, the parents of the spouse and other persons, which are acquirer, the donor or they live with the deceased at least for one year before the death or the transfer in a common household, and that for this reason they took care about their common household or were dependent on the acquirer, the donor or the deceased. In the third group (further only 3<sup>rd</sup> group) are then located all other natural and legal persons.

Table 2. The comparison of selected differences between the previous and the current legislation – the issue of inheritance.

Selected areas	Previous legislation	Current legislation
Legislation	Act No. 357/1992 Coll., on inheritance tax, gift tax and real estate transfer tax	Act No. 586/1992 Coll., income tax
Force	Until the 31 <sup>st</sup> December 2013	From the 1 <sup>st</sup> January 2014
Taxpayer	The heir, who acquire heritage.	The heir (natural person or legal person), who acquirer the gratuitous income.
Object of taxation	The acquisition of property by inheritance. As a property is considered: real estate, movable assets, securities, cash in Czech and foreign currency, receivable, property rights and other property values.	The natural persons: Incomes from employment, incomes from entrepreneurship, incomes from capital property, incomes from rental and other incomes. The legal persons: incomes from all the activities and from the loading with all assets.
Tax base	The price of acquired property to each heir reduced by: the proved debts of the deceased, the adequate costs associated with the funeral of the deceased, the fees and cash outlays of a notary authorized by the Court to acts in the proceedings on the heritage and heritage dose paid in another state from the acquisition of property in a foreign countries.	The natural persons: the amount by which the taxpayer’s incomes exceed the expenses to achieve, maintain, and provide incomes ( <i>note: if it is not in § 6 to § 10 otherwise specified</i> ) The legal persons: The difference between incomes excesses the expenditure. In the case of a taxpayer which is an accounting unit, it is a difference between revenue and costs, which must be further modified according to the Income Tax Act.
Tax rate	By inheritance tax for persons listed in 1 <sup>st</sup> group: from 1.0 % to 5.0 % of the tax base; for persons listed in 2 <sup>nd</sup> group: from 3.0 % to 12.0 % of the tax base; by the persons listed in 3 <sup>rd</sup> group: from 7.0 % to 40.0 % of the tax base.	The natural persons: 15 % of the tax base ( <i>Note: the solidarity increase of tax amount is 7 % of the positive difference between the sum of incomes of the partial tax base from § 6 and partial tax base from § 7 of Income Tax Act</i> ). The legal persons: 19 % of the tax base.
Tax calculation	Tax base x tax rate of inheritance tax x coefficient 0.5	The natural persons: Tax base x tax rate ( <i>Note: in the calculation of the final tax liability may still enter the so-called solidarity tax increase defined in § 16a of Income Tax Act</i> ). The legal persons: a modified tax base x tax rate.
Tax exemptions	The acquisition of property by inheritance, if it occurs between persons in 1 <sup>st</sup> and 2 <sup>nd</sup> group.	The natural persons: § 4a paragraph 1 (a) Income Tax Act – the gratuitous income obtained from the inheritance or in disposition. The legal persons (business)*: § 19b paragraph 1 (a) Income Tax Act – the gratuitous income obtained from the inheritance or from the disposition.
Conditioned exemptions	From the inheritance tax are according to § 19 paragraph 2 IGRET: movable personal assets of a natural person, deposits on accounts in banks, cash in Czech or foreign currency and securities if their total value does not exceed 20 000 CZK by persons in 3 <sup>rd</sup> group and heirs share of the minor.	Xxx

Source: authors \*in the framework of the research is not given the interest to gratuitous incomes by the public beneficial taxpayers.

Table 3. The comparison of selected differences between the previous and the current legislation – the issue of donation.

Selected areas	Previous legislation	Current legislation
Legislation	Act No. 357/1992 Coll., on inheritance tax, gift tax and real estate transfer tax	Act No. 586/1992 Coll., income tax
Force	Until the 31 <sup>st</sup> December 2013	From the 1 <sup>st</sup> January 2014
Taxpayer	Acquirer*	Natural persons, legal persons
Object of taxation	A gratuitous acquisition of assets on the basis of the legal act or in connection with a legal act. As a property are considered: real estate, movable assets and other property benefits.	The natural persons: Incomes from employment, incomes from entrepreneurship, incomes from capital property, incomes from rental and other incomes. The legal persons: incomes from all the activities and from the loading with all assets.
Tax base	The price of the property that is the object of the taxation reduced by: the proved debts and the price of another obligation, the value of property exempted according to the IGRET, duty and taxes paid on import (for the movable assets donated or brought from abroad).	The natural persons: The amount by which the taxpayer's incomes exceed the expenses to achieve, maintain, and provide incomes ( <i>note: if it is not in § 6 to § 10 otherwise specified</i> ). The legal persons: The difference between incomes exceeds the expenditure. In the case of a taxpayer which is an accounting unit, it is a difference between revenue and costs, which must be further modified according to the Income Tax Act.
Tax rate	The gift tax by persons listed in 1 <sup>st</sup> group: from 1.0 % to 5.0 % of the tax base; by persons listed in 2 <sup>nd</sup> group: from 3.0 % to 12.0 % of the tax base; by persons listed in 3 <sup>rd</sup> group: from 7.0 % to 40.0 % of the tax base.	The natural persons: 15 % of the tax base ( <i>Note: the solidarity increase of tax amount is 7 % of the positive difference between the sum of incomes of the partial tax base from § 6 and the partial tax base from § 7 Income Tax Act</i> ) The legal persons: 19 % of the tax base.
Tax calculation	The gift tax = tax base x tax rate x coefficient 0.5  The gift tax: gratuitous acquisition of the property, if it occurs between persons in 1 <sup>st</sup> and 2 <sup>nd</sup> group.	The natural persons: Tax base x tax rate ** The natural persons: a modified tax base x tax rate According to § 10 paragraph 3 (d) Income Tax Act are tax exempt the gratuitous incomes from a relative in the straight line and from the indirect line, in terms it is sibling, uncle, aunt, nephew or niece, husband/wife, a child of spouse, the parents of spouse or husband's / wife's parents. Also from a person, whom the taxpayer lived for at least one year before getting the gratuitous income in the common household and for this reason he took care or was referred to this person.
Tax exemptions		Xxx
Conditioned exemptions	The conditioned exemption from the gift tax according to § 19 paragraph 4 IGRET: the acquisition of movable personal assets of a natural person, acquisition of deposits on accounts in banks, cash in Czech or foreign currency, securities in the Czech republic, if their total value does not exceed 20 000 CZK by person in 3 <sup>rd</sup> group; acquisition of other assets acquired on the basis of the loan contract; the acquisition of the occasional gratuitous movable assets and other assets, whose value does not exceed 3 000 CZK.	

Source: authors \*Note: the exception: by gratuitous provision of property by a natural person, who has a permanent residence in the Czech Republic, to a natural person, who does not have a permanent residence in the Czech Republic, of a legal person, who does not have headquarters, is the taxpayer of the gift tax everytime the donor. \*\* Note: to the calculation of the final tax liability can also enter so-called solidarity tax increase defined in § 16a Income Tax Act.



Table 4. The comparison of selected differences between the previous and the current legislation – the issue of real estate transfer.

Selected areas	Previous legislation	Current legislation
Legislation	Act No. 357/1992 Coll., on inheritance tax, gift tax and real estate transfer tax	The legal measures of the Senate No. 340/2013 Coll., on tax of the acquisition immovable property
Force	Until the 31 <sup>st</sup> December 2013	From the 1 <sup>st</sup> January 2014
Taxpayer	Transferor (the seller); Acquirer*; Transferor and acquirer** The paid transfer of ownership to real estate	The transferor of the real estate ownership***; acquirer of the ownership The paid acquiring real estate ownership, that is: parts of the grounds, building, a part of engineering net or civil engineering unit on the area of the Czech Republic, law construction by grounds on the area of tze Czech Republic, a co-owner share on the real estate.
Object of taxation		The acquisition value reduced by the accepted expenditure.
Tax base	The price negotiated under a special legal regulation, valid in the date of acquisition of the real estate.	4 % of the tax base
Tax rate	The real estate transfer tax by persons listed in 1 <sup>st</sup> , 2 <sup>nd</sup> and 3 <sup>rd</sup> groups is 4 % of the tax base.	Tax base x tax rate
Tax calculation	The real estate transfer tax = Tax base x tax rate	
Tax exemptions	The real estate transfer tax – transfers and transition of real estate ownership, which is in the property of the state (or where the state is co-owner).	The exemption can be used for new buildings and for units in compliance with the conditions.

Source: authors (Note: \*With regard to the acquisition of real estate in the enforcement of a decision or execution by special legal gelationon, expropriation, prescription in insolvency proceedings after the bankruptcy decision or by public auction or by the acquisition of the property on the base of the Treaty on the rights transfer, in connection with the assignment of the receivable, if the legal person is canceled without elimination or by dividing of liquidation balance when the legal person is canceled with the elimination; \*\* with regard to exchange of real estate, the transferor and acquirer are in this case required to pay tax jointly and non-differently; \*\*\* with regard of acquisition of ownership by purchasing or exchange and transferor and acquirer do not make an agreement in the contract of purchase, the taxpayer is an actuirer.

#### 4. Conclusion

The literature focused on the tax effect of family business succession is quite poor. The authors are more usually focused on the issue of family business succession from the other aspects, such as the characteristic and specifics of family businesses. The main aim of the research was to identify the tax effects of a gratuitous transfer in the framework of succession in family businesses. There was provided a solution of selected model situations and its tax effects of gratuitous incomes in family business. The paper also includes a comparison of selected differences between the previous and the current legislation in the case of donation of the enterprise, the heritage and the real estate transfer.

The intention was to help family businesses with this issue. On the basis of the research were confirmed the differences between solutions of ownership transfers in family and non-family types of enterprises. In the case of family businesses are very often used those different cases of gratuitous transfers, which have different tax effects. The results of the research opens an opportunity for the next research focused on the area of paid transfers in family business and transfer of entrepreneur's shares in the conditions of SMEs.

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