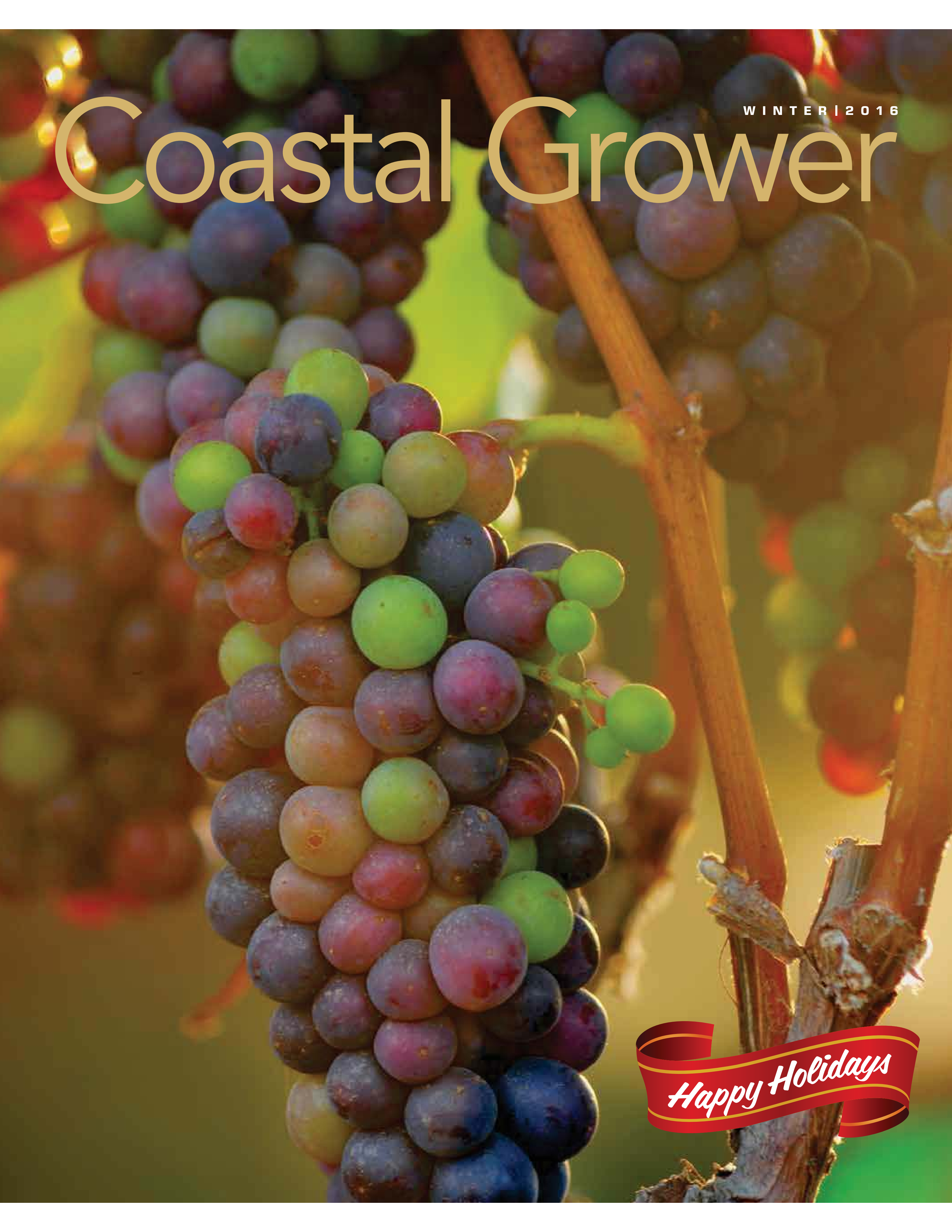
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Transferring Family Wealth in a Changing Tax Environment

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Proposed changes to the taxation of intra-family business transfers:

The United States Treasury Department recently issued Section 2704 Proposed Treasury Regulations that may drastically alter asset valuation determination and transfer methods traditionally used in estate, gift, and generation skipping tax planning. If approved in their current form, the final Section 2704 Proposed Treasury Regulations would significantly reduce or eliminate valuation discounts on intra-family transfers of family owned business, corporate, partnership, and limited liability company (LLC) interests.

TRADITIONAL TAX PLANNING STRATEGIES:

Each taxpayer may cumulatively transfer gifts free of tax throughout their lifetime and at death up to the allowable lifetime estate exclusion amount ($5,450,000 in 2016). An annual gift exclusion amount of $14,000 per transferee is currently excludable from gift tax each year and does not impact the transferor's cumulative lifetime estate exclusion amount. Taxable transfers at death and gifts in excess of the lifetime exclusion amount are taxed at 40 percent. Currently, when planned properly, taxpayers are able to transfer property to family members at less than full market value. This is accomplished by applying appropriate discounts to the transferred property.

Valuation discounts are a frequently utilized, effective, and efficient method of preserving and transferring family wealth. A qualified appraisal that considers discounts for lack of marketability, lack of control, or undivided fractional interests in property will typically discount the fair market value of the transferred interest by 25-40 percent.

Consider a taxpayer that owns a 100 percent interest in a business entity with a fair market value of $10 million. The taxpayer wishes to transfer a portion of his/her ownership interest to the next generation. Assume that the business interests could be discounted by 40 percent, resulting in 60 percent of the asset being reported as a taxable gift or includable in the decedent's taxable estate. The transferred interest is then held by the next generation(s) and growth can continue without further estate tax implications to the original transferor with respect to this asset. This strategy works well when the transferred interest is intended to be held by the transferee for many years.

CHANGES UNDER THE PROPOSED REGULATIONS:

The proposed Section 2704 regulations, if finalized in their current form, would severely limit or disregard valuation discounts on intra-family transfers of family controlled corporations, partnerships, and LLCs. The Treasury maintains that, although marketability, liquidity, and transferability restrictions exist for minority, non-controlling interest holders, the family as a whole retains these powers through their ability to act collectively.

There are numerous planning options available as alternatives to the traditional methods used, many of which may prove more beneficial than the commonly used business valuation discounts.

Consider the example posed above in which a 100 percent controlled business with a fair market value of $10 million is transferred to family members as non-majority, non-controlling, restricted ownership interests. If the proposed Section 2704 regulations are finalized in their current form, the previously allowable valuation discount of $4 million would be substantially reduced or entirely eliminated. The business would be transferred at (or close to) its fair market value of $10 million. Eliminating the valuation discounts

could, in this scenario, result in up to $1.6 million in additional estate taxes. Estates lacking liquidity, such as businesses that are highly leveraged or farms that hold much of their value in land, could face increasing pressure to sell assets of the business in order to pay estate taxes.

Additionally, any transfer of an interest to a family member made within three years of the transferor's death that is still held and controlled by the family, could be pulled back as an asset includible in the transferor's estate. Effectively, the transferor's estate would include as part of the value of the taxable estate, the fair market value of an asset owned by another individual.

WHO WOULD BE IMPACTED?

The proposed Section 2704 regulations are specific to family owned and controlled businesses, corporations, partnerships, and LLCs where intra-family transfers are made. Comparable businesses that are not family owned would retain a tax advantage as valuation discounts would remain a valid planning tool in the transfer of ownership. For effected businesses, tax liabilities may become prohibitive and the generational continuance of many family owned businesses impossible without the implementation of alternative planning techniques.

PLANNING STRATEGIES:

There are numerous planning options available as alternatives to the traditional methods used, many of which may prove more beneficial than the commonly used business valuation discounts. For example, family businesses could continue to utilize valuation discounts where fractional interests in real estate property are held by individuals, trusts, family partnerships, LLCs, or family members in joint tenancy arrangements.

For assets that are expected to appreciate in the future and prior to the transferor's passing, an irrevocable Grantor Trust may be a beneficial planning tool. Assets can be gifted or sold to a Grantor Trust at their current fair market value. The income and appreciation can accumulate inside the trust tax-free since the Grantor Trust income tax rules require the trust's income be reported on the grantor's personal tax return.

A taxpayer could sell his/her interest in an appreciating business or business assets to an irrevocable Intentionally Defective Grantor Trust (IDGT) for the benefit of children and grandchildren. The IDGT is a Grantor Trust for income tax purposes, and thus no gain or loss is recognized on the sale of the assets to the trust. The trust could be funded initially with a cash gift equal to approximately 10 percent of the fair market value of the asset being sold. A promissory note with no prepayment penalties should then be issued to the taxpayer for the fair market value of the transferred assets at the then current applicable federal interest rate. The promissory note could then be used to fund a Grantor Retained Annuity Trust (GRAT) at a discounted value. The installment payments due the taxpayer would be paid to the GRAT from income generated in the IDGT. All income and appreciation would accumulate in these two trusts and would remain separate from the transferor's estate.

There are many other strategies and combinations of strategies available, and the specific assets, facts, and circumstances associated with a taxpayer's estate will dictate the appropriate techniques for the most favorable income, estate and gift tax outcome.

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WHO MAY BENEFIT?

Taxpayer's with an estate that is under the current lifetime exclusion amount may benefit from the implementation of the proposed Section 2704 regulations. Without valuation discounts, assets held by the transferor with a low cost basis could receive a step-up to their fair market value on the date of the transferor's death. Provided the step-up does not create a taxable estate, the added basis would help to preserve family wealth by reducing the gain and resulting tax if the asset were sold in the possession of the transferee.

ACTION ITEMS:

On December 1, 2016, the Treasury Department held a public hearing to receive comments from the public to discuss the proposed final Section 2704 regulations. If finalized, the regulations would go into effect 30 days after they are issued. Their retroactive effects are unclear at this time; specifically, the extent transfers of interests in the three years prior to the transferor's death may be pulled back into the transferor's estate for estate tax purposes.

Taxpayers are advised to contact their estate planning attorney and accountant as soon as possible to discuss valid income, estate, and gift planning strategies. It is imperative that taxpayers wishing to take advantage of valuation discounts on intra-family transfers take immediate action if/while they are still available. Additionally, taxpayers who have made intra-family transfers of business interests within the last three years may benefit from legal counsel. CG

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