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VALUATION DISCOUNTS IN MODERN ESTATE PLANNING

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FOR MOST FAMILY BUSINESS OWNERS, THE OLD WAY OF DISCOUNT PLANNING HAS BECOME PERISHABLE.

For many years, closely-held business owners routinely heard estate planners advise them to give or sometimes sell family members' interests in the business (sometimes outright and sometimes in trust) to reduce transfer taxes: gift tax, estate tax and even generation-skipping transfer tax.

This type of planning allows business owners to take advantage of valuation discounts by fragmenting business ownership to reduce a business' value for estate planning purposes without necessarily causing the senior generation owners to lose control of the company. This planning can be very effective for business owners who expect their estates will be subject to transfer taxes on death.

These days, however, the transfer tax exemptions are so large that many, if not most, taxpayers will never be subject to them. In those situations, estate planning which fragments business ownership using fractional valuation discounts may be counterproductive from a tax planning standpoint.

For example, consider the Marker family. Price and Inka own a grocery store corporation as community property. They each give their children, Lyn and Garvey, 5 percent of the stock. Now, the parents each own 45 percent of the stock, the children each own 5 percent, and no single owner has majority control of the corporation.

This can be effective transfer tax planning if the Markers' overall estate is large enough to trigger estate tax at some point; however, it can be poor income tax planning if the estate is not expected to reach that level. This is because the transfers reduce the overall income tax basis of the stock when compared to what it would likely be if held in the estate of the surviving spouse.

The best overall tax planning might be to have the surviving spouse ultimately own the entire corporation. (Note, however, that there may be reasons for a different approach not discussed here, depending on the circumstances).

Under the valuation standard that applies for wealth transfer planning, we look at what a buyer would pay for each particular interest. A buyer would not pay 45 percent of the corporation's value for 45 percent of the stock if that stock did not give the buyer 45 percent of the voting rights. This is because the buyer would become a minority owner who could not control corporate decisions and could not sell the stock on an exchange.

In this situation, a buyer would insist on discounting the stock value for this lack of control and lack of marketability. Discount levels depend on each case but can approach 50 percent of the undiscounted value. The fact that we are dealing with an entity comprised of related owners is irrelevant.

We do not value the entity as a unit; instead, we look at each interest separately. In this example, all owners have minority interests, and for valuation purposes, the sum of the parts does not equal the whole.

These valuation discounts have been quite popular in estate planning during recent decades. Discounts have allowed business interests to pass by gift or through estates at lower values. That has often reduced the estate tax (for transfers through estates) and gift tax (for lifetime transfers). These reduced transfer taxes have reduced the cost of transferring family entities to the next generations.

But there is a catch: as these interests pass through estates, they generally receive a new income tax basis equal to the market value of the property interest in the estate, which usually gives the recipient of the property a step up in basis for property that may have been held many years. In contrast, when a donor makes a lifetime gift of appreciated property, the donee receives their income tax basis.

A market value basis adjustment can reduce income taxes significantly. Because gain on the sale of an asset equals the amount realized minus basis, the new basis adjustment reduces or sometimes eliminates gain as family members sell interests received through estates.

The market value basis adjustment applies only to property held in an estate (even if in a revocable trust). Discounts from fragmented ownership may be counterproductive because they reduce a positive basis adjustment in an estate and can increase taxable gains.

This loss of a basis adjustment can be the price for avoiding a 40 percent estate tax (and equivalent generation-skipping transfer tax in some instances). However, under current law, each person may transfer up to $11.18 million through an estate (lifetime taxable gifts reduce the amount available in the estate). For couples, each has that exemption and may transfer the exemption to the survivor, which means married couples can transfer up to $22 million in life or in death free of transfer tax.

Yet, despite the adage that nothing is certain but death and taxes, we now have some uncertainty: the recently-doubled exemption is scheduled for a 50 percent sunsetting reduction in 2026. Yet, even if that reduction occurs, large estates may still be exempt from these transfer taxes depending on when the gift was made.

Fragmenting closely-held business ownership to discount the family's overall business value as described above can be great tax planning when estate taxes will likely be paid. Conversely, it may be bad planning if the estate is unlikely to be large enough to pay estate taxes. In that case, the better planning can be to avoid fragmented ownership in order to preserve value and produce the best income tax basis adjustment possible as entity interests pass through estates. In other words, the best tax planning depends on the expected size of the estate and can point in opposite directions, depending on the situation.

The estate and gift tax exemptions are now so large that most people and their estates will never pay these taxes and the valuation discount planning we have seen in recent decades is giving way to a different type of thinking about wealth transfer and family succession planning – the focus has shifted from the creation of discounts to avoid estate and gift tax, to the preservation of income tax basis for transferred assets. For most family business owners, the old way of discount planning has become perishable. ▪

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