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Family Transfers, Part II: Gifts

By Lou Vlahos

This is part two of a five part series.

In an earlier article, we noted that a parent who owns a business faces some difficult issues regarding the disposition of that business among his or her children. Among the options to be considered is a sale of the business, which would allow the parent to treat the children equally, inasmuch as each may share in the proceeds of the sale. However, a sale may not represent the best long-term economic choice where the business is profitable and growing, and where at least one of the children is capable of operating the business. In that case, the parent must consider how to transition ownership of the business to his or her family.

The tax laws have historically hampered the ability of business owners to transfer their interests in the business to their children, with the main obstacles being the gift tax and the estate tax, though the income tax has also been an important consideration.

In the last few years, Congress has made some significant changes in the gift, estate, and income tax planning landscapes. The likelihood of more changes is far from remote. Thus far, these changes have not directly targeted any specific intra-family transfer vehicles, though there are several proposals outstanding which aim to do just that; for example, short-term and zeroed-out GRATs, GST-exempt dynasty trusts, and transactions with grantor trusts have all been highlighted as potential targets. Until Congress acts, however, these transfer techniques remain viable and, when combined with the recent tax changes, in particular, the increased gift tax exclusion and GST exemptions amounts. They provide a parent with the tax-efficient means for reducing his or her taxable estate while benefiting the family.

The following summarizes the tax goals of a gifting program as they relate to interests in a family business. It also describes the various transfer methods by which these goals may be attained.

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Goals of Gifting

Generally speaking, one goal of gifting property to a family member is not only to remove the value of such property from the parent's estate, but also to "remove" any subsequent appreciation in the value of that property from the estate. A taxpayer's sale of appreciating property to a child in exchange for a promissory note will freeze the value of the property in the parent's hands at the amount of the note, while shifting the property and any appreciation to the child.

Had the parent not transferred the property during his or her life, the full value of that property as of his or her date of death would be included in his estate and be subject to transfer tax.

Another goal of gifting is to position the remaining business interests held by the parent in a more favorable valuation posture for estate tax valuation purposes (for example, by putting the parent in a minority interest position).

What is a Gift?

Before exploring the various transfer vehicles by which a parent may transition business interests to a child (which will be covered in the next post), it would be helpful to lay some conceptual groundwork.

When a parent gives property to a child, no gift has occurred if the parent receives adequate and full consideration in exchange for the property transferred.

A gift occurs, in most cases, if the consideration received is less than the fair market value ("FMV") of the property transferred. In that case, the amount of the gift is equal to the excess of the FMV of the property transferred over the amount of the consideration received; to the extent that adequate consideration has been received, there has been a taxable sale of property by the transferor. A part-sale/part-gift may occur where the business interest transferred "by gift" is "subject" to a liability and the child "assumes" that liability, a not infrequent event in the case of interests in a partnership or LLC.

It should be noted that a transfer made "in the ordinary course of business" is not treated as a gift even though the parent-transferor does not, strictly speaking, receive full consideration. A genuine business-related transfer qualifies for this exception if it is bona fide, at arm's-length, and free from donative intent (for example, a transfer ostensibly in exchange for services). However, the taxpayer must be prepared to overcome the IRS's predisposition to find a gift in a family setting.

Valuation

If a transfer of a business interest is a completed gift (and we will assume for our purposes that all of the transfers described herein are), the amount of the gift (i.e., the amount on which the gift tax is imposed), is the FMV of the interest on the transfer date.

The valuation of property for gift and estate tax purposes is based upon the "hypothetical willing buyer and willing seller" standard. In other words, it does not consider the actual transferor and transferee, and their relationship to each other (e.g., family) does not matter. These hypothetical individuals are under no compulsion to buy or sell, and they are each deemed to have reasonable knowledge of all the relevant facts (including, in most cases, the fact that the other owners of the business may be related to one another).

In the case of stock in a closely-held corporation or partnership, the FMV of an interest depends on the relevant facts and circumstances of each case. The IRS has set forth many of the factors to be considered (e.g., economic outlook, earning capacity, goodwill, the size of the interest to be transferred, etc.). The courts have accepted appropriate discounts in valuing these interests where they represent minority positions for which there is no ready market. Among these are the discounts for lack of control (LOC) and for lack of marketability (LOM). The application of these discounts does not yield a predictable discount for any given valuation scenario, since each presents a unique set of facts.

Thus, if the interest being transferred by way of a gift is a minority interest in a closely-held entity for which there is no ready market, a hypothetical willing buyer will realize that he cannot easily realize the pro rata value of the entity to which the minority interest "entitles" him. He or she cannot force a dividend distribution, a sale or a liquidation — it will be difficult to convince another hypothetical party to purchase his or her interest. Under these circumstances, the courts and the IRS have recognized that various discounts may be applied to the so-called "normative" value of an equity interest in order to determine its fair market value.

Conversely, if the parent transfers a majority interest in the entity, which interest enables the holder (the child-transferee) to control the operation of the business, to cause it to make distributions to its owners, to sell the business or to liquidate it, etc., then the value of such interest is determined without regard to the discount for lack of control, though marketability discounts should still apply (depending, in part, upon the assets of the business).

Position for Estate Tax valuation

This valuation reality supports the wisdom (from a tax perspective) of making gifts of minority interests in the family business to family members. It also presents another benefit for lifetime transfers to family. Not only may such transfers remove the appreciation of the interests from the parent-donor's estate, they may also cause the interests retained by the parent to fall below 50 percent of the total outstanding equity of the business. In other words, it may cause the parent to become a minority owner, which, at his or her death, will cause the parent's remaining equity interest to be valued with the benefit of discounts for LOC and LOM.

Other considerations

Before describing some of the vehicles that are typically utilized in transferring business interests to family members, we should consider whether the parent's transfer would make sense from various perspectives in addition to the estate tax.

- First, and foremost, does the transfer make business sense? We will assume for our purposes that it does; otherwise, the discussion should end at this point.

- Second, can the parent "afford" to make the transfer; i.e., does the parent need the income stream generated by the business interest, and is the parent "comfortable" with giving up ownership of the interest?

- Third, what are the gift and estate tax benefits of the transfer? A gift will remove the business interest and its future appreciation from the parent's estate. It may reduce the value of the parent's remaining interests in the business (much the same way that inter-spousal transfers do, *a la* Bonner and Mellinger).

However, with the increased gift tax exclusion – and its unification with the estate tax – to $5.34 million in 2014 ($10.68 million per married couple), the indexing of the exclusion amount for inflation, and the ability of a surviving spouse to utilize the unused exclusion amount of a pre-deceasing spouse (the so-called "portability" election), the estate tax-based justification for gifting business interests may be much diminished for many parent-business owners.

Indeed, from the perspective of many business owners, depending upon the anticipated value of their taxable estate, the better tax plan may be to hold on to the business until their date of death. In this way, they can secure a step-up in the adjusted tax basis of the business interests. This will enable the beneficiaries of their estates to secure certain income tax benefits, including the reduction of gain on a subsequent sale of either the interests or of the assets of the business (depending upon some other factors), or the reduction of ordinary income as a result of increased depreciation or amortization deductions (for example, as the result of an IRC Sec. 754 election). This will be the subject of a later article.

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