Lifetime Gifting of Family-Owned Businesses – Move Quickly to Avoid Higher Taxes

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Many family businesses are held in family limited partnerships ("FLPs") or limited liability companies ("LLCs"). A parent typically transfers ownership of the family business by gifting interests in the FLP or LLC to his or her child or children. For now, the gift of the FLP or LLC interest will qualify for substantial valuation discounts (which can range from 15% to 40%) for minority interest and lack of marketability, thereby reducing or eliminating the parent's transfer tax costs (i.e., estate and gift taxes). These discounts reflect the fact that the interests the parent transfers to a child gives the child no control over the management of the family business, and there is no readily available market in which to sell that particular interest in the family business.

For example, assume you own an LLC that holds commercial real property worth $5 million, and you want to transfer 20% of the company to your daughter. Twenty percent of the company would be worth $1 million. Currently, however, based on restrictions in the partnership or shareholder's agreement, the $1 million value could be discounted by 35%, and the value of the interest transferred to your daughter would be $650,000 ($1,000,000 – [1,000,000 x 35%]). The discount would be $350,000. Based on the current estate and gift tax rate of 40%, the transfer tax savings due to the discount is $140,000 ($350,000 x 40%).

The U.S. Treasury Department has issued proposed regulations under section 2704 of the Internal Revenue Code that would severely limit or eliminate the valuation discounts explained above. Hearings on these proposed regulations are scheduled for December 1st and, once they become final, they become effective 30 days thereafter. It is possible that these regulations could be effective as early as the end of December, 2016, and transfers of interests in family owned businesses to children thereafter would lose the valuation discounts.

If you have a family business that you are planning to pass down to your children, it would behoove you to speak with your tax professional as soon as possible so you can make an informed and timely decision on making such transfers and fully understand the tax consequences of such transfer, now and/or later.

If there is a trusts or estates topic that you would like to know more about, please feel free to email me at pmarcin@farrellfritz.com with your suggestion and I will do my best to cover it in a future column.

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