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Trusts and Estates

Time May Be Running Out for Family Business Entity Discounts

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On Aug. 2, the U.S. Department of Treasury issued long-awaited proposed regulations under Section 2704 of the Internal Revenue Code, which are designed to eliminate the opportunity for "discounts" on inter-family gifts of interests in family controlled business entities. For this purpose, a family is considered to "control" a business entity if it collectively controls 50 percent or more of the vote under an intricate and comprehensive scheme of "attribution" rules among family members. The earliest date on which the proposed regulations would become final appears to be Dec. 1, so, there remains an opportunity for families that act quickly and diligently to still have a chance of engaging in planning with discounts, at least until that date.

Planning to lock in discounts for transfers of family-owned business entities has been a key component of estate planning for many high net worth families facing a steep federal estate tax at death for decades. The tax planning goal of such transfers is generally two-fold: to eliminate future growth on the asset from a client's taxable estate and to take advantage of the opportunity to secure discounts related to the recipient's lack of control over the transferred asset (by utilizing a discount, the client is reducing the taxable value of the transfer being made). Even if the IRS is able to succeed in its goal of eliminating the discounts, families will still be able to benefit from making transfers of assets before death to allow future appreciation to escape the federal gift and estate tax system.

Discounts for these types of transfers have typically been in the range of 30 to 40 percent. They are based on the reality that a willing buyer would generally pay less for an interest in a business entity that the buyer can't control than one that the buyer can control. A discount on this basis is referred to as a "minority interest" discount. Another layer of discounting has been available for the "lack of marketability" of an interest for which there is not a public market (such as the NYSE) to easily make a sale.

This type of planning has often been referred to as "family limited partnership" planning irrespective of whether a limited liability company, limited partnership, or corporation is involved. While the concept of applying discounts to transfers in such entities arose in the context of estate planning for operating businesses, it has also been applied to entities

created to manage more passive investment assets for a family, such as marketable securities and investment real estate. In recent times, the IRS has most prominently challenged tax savings claimed by families who made transfers of interests in this type of family controlled business entity. However, the Section 2704 proposed regulations, as they now stand, do not distinguish between entities conducting an active business from those with more passive investment activities.

For individuals with assets in excess of the federal estate tax exemption of $5.45 million available to them, it is worth considering engaging in a transaction for which discounts might be available as soon as possible so there will be a possibility of completing it before the proposed regulations become effective. There have never been any guarantees with this type of planning that discounts will be accepted by the IRS on audit, but, in many cases they have been successful. It is extremely important to balance out the opportunity for a family to benefit from a tax basis step-up at death for capital gains (and recapture) tax purposes under Internal Revenue Code Section 1014 when structuring transactions to benefit from a discount to save federal estate taxes.

For low-basis assets without a significant amount of future growth potential, an inter-vivos transfer to lock in a discount is often ill advised. As a rule of thumb, a low- (or no-) basis assets should be expected to appreciate by at least 150 percent before death for the benefit of locking in the discount through an inter-vivos transfer to outweigh the benefit of a basis step-up at death. Taxes on capital gains, after factoring in both state and federal level taxes, and including the relatively new "Medicare tax" of 3.8 percent, can generally range from 15 to 28 percent, depending on which state might impose an income tax on the gain and the tax bracket of the applicable taxpayer. The "recapture" tax on depreciated assets such as real estate, imposed at either the 25 percent rate or ordinary income tax rates, is yet another consideration that must be factored in where relevant.

As an example of how this type of planning can benefit a family, let's consider the following fact pattern. Assume mom and dad have a total asset base of $21 million, leaving approximately $10 million of assets subject to tax if they were to both die in 2016 with exemptions of approximately $11 million available to both of them. With a 40 percent federal estate tax, $4 million would be payable as a result of their deaths with no planning. If $20 million of their estates is attributable to a family business they own, they might be able to enter into transactions to lock in a discount of up to 40 percent on interests they transfer to their children (or trusts for their benefit). Let's say they gift or sell 90 percent of their business interests to their children, for interests worth $18 million. A 40-percent discount on such interests would equate to a reduction of $7.2 million in value, for a potential estate tax savings of $2.88 million at the current federal estate tax rate of 40 percent. To the extent the business interests are sold, it is assumed that distributions from the business to the buyers would be more than adequate to pay any interest due on a promissory note issued in the transaction.

If mom and dad had a tax basis of $18 million in the transferred family business interest (a rare scenario), this could be a slam dunk because there was no "cost" in lost basis step-up to secure the estate tax savings. However, if mom and dad had a zero tax basis, the lost opportunity to secure the basis step-up at death would have to be factored in. Applying a hypothetical 26 percent effective capital gains tax rate, the value of the basis step-up on $18 million of assets would be about $4.7 million, so, at first glance, it appears to be a self-defeating move to trade the basis step-up for the discount. However, if it turns out that the

business is sold during mom and dad's lifetime, so no basis step-up would have been available at death, it might have been worthwhile, particularly if a grantor trust structure was implemented so that mom and dad can pay all or part of the capital gains tax on the sale.

Alternatively, if the business grows by 150 percent before mom and dad have both passed away, the discounting would likely be beneficial. In this scenario, a transferred interest that was originally worth $18 million (without discounts) has now grown by $27 million to be worth $45 million. So, there would be an additional estate tax savings of $10.8 million as a result of the transfer. A total of $13.68 million of estate taxes would be saved, after adding this to the $2.88 million of savings on the initial discounts. The lost basis step-up "cost" at 26 percent would be $11.7 million, resulting in a net tax savings of $1.98 million (note that the entire amount of the savings here would be attributable to the discounts). In Pennsylvania, this savings could be enhanced by the state inheritance tax savings of about $2 million at the 4.5 percent rate for transfers to lineal descendants, which is reduced to a net benefit of $1.2 million after taking into account the available state death tax deduction for federal estate tax purposes. So, the total potential tax savings could be about $3.2 million. The savings might be greater if earnings from the business that had been distributed to the junior generations before mom and dad's deaths had also escaped imposition of the federal estate tax.

Because the future of both the federal estate tax and capital gains tax rates and structure remains uncertain, the tax benefits of locking in discounts could be more or less depending on how these taxes might evolve. The estate tax rate has been as high as 55 percent in the recent past, and the exemption has been as low as $600,000. Donald Trump has proposed eliminating the estate tax in the future, and Hillary Clinton has proposed increasing the rate to 45 percent and decreasing the exemption at death to $3.5 million and during life to $1 million. As for the federal capital gains tax, it has been imposed at rates as high as 28 percent in the relatively recent past, and last year President Obama had proposed reverting to that rate once again.

Families must also plan for a possible IRS attack at death under Internal Revenue Code Section 2036. In situations where the senior family member has maintained control at death over entities in which discounted interests were transferred by such a senior family member, the IRS has taken the position that all of the transferred interests are includable in the estate of the senior family member. This attack, when successful, can cause both the discounted amount and the appreciated amount to be subject to tax at death with the result that the entire transaction might ultimately be of little or no benefit.

This type of estate planning is not for the faint-hearted. But, in the right circumstances, a significant amount of tax savings can be generated for a family by careful and proactive planning while the current rules for discounting remain in effect. •

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