

PROPOSED IRS CHANGES WILL BE BAD NEWS FOR FAMILY BUSINESSES

Author(s): Trainor Fairbrook

Proposed changes by the IRS to increase taxes are causing a stir in the estate planning world. In August 2016, the IRS published proposed Treasury Regulations that, if put into effect, will make it more expensive for business owners to transfer assets to heirs. Specifically, the IRS intends to eliminate the use of discounting business interests when the interests are transferred to family members, whether through gifting during the owner's lifetime or at the owner's death.

For decades, individuals have utilized discounting when gifting or transferring ownership interests in family-held businesses. Discounting works as follows. Typically, the family members agree to restrict transfers to non-family members as a means of limiting who can become an owner of the business. Due to this limitation affecting marketability and the fact that third party buyers would not be interested in joining a family business, valuation experts routinely apply a discount for lack of marketability and control to the overall value of the business (which discounts have been respected by the IRS). The result is the business interest is valued at a smaller amount. This discount can be up to 40% of the company's value. If the IRS's proposal to eliminate discounting is adopted, business owners will pay more taxes upon transfer (whether during their lifetime or upon death). In the event of the death of an owner of a family business, the proposed regulations could mean increased estate taxes, possibly forcing their children/beneficiaries to liquidate the business or sell off portions of the business to pay the taxes.

Here is a simple illustration of how the IRS's proposed elimination of discounting upon death could affect a family business. Federal law now provides that an individual decedent's estate below \$5.45 million is not subject to estate tax. (In our example, the business owner has not previously used any of his or her gifting exemption.) Anything in excess of that amount is taxed at a rate of 40%. If our hypothetical individual's estate consists of just the family business valued at \$8 million, his or her estate will be subject to a 40% estate tax on \$2.55 million (\$8.0M - \$5.45M). Therefore, following the individual's death, 40% of \$2.55 million (approximately

\$1.02M) in estate tax will be due upon the individual's death. If discounting was utilized as described above, up to a 40% discount on the family business interest could be applied. In that scenario, the overall value of the estate is reduced to \$4.8 million (instead of the original \$8M), resulting in no estate tax due. The \$1.02 million in taxes that would otherwise be paid to the Federal government is instead inherited by the heirs.

Business owners often gift portions of the family business to their children during their lifetimes. Discounting is a useful tool when gifting, because the interest will be assigned a reduced value for gift tax purposes. Currently, as indicated above, each individual may gift \$5.45 million during his or her lifetime, plus an additional \$14,000 per beneficiary per year. Any gifted amount over \$14,000 per year is subtracted from the donor's \$5.45 million estate tax exemption, which means that gifts of valuable business interests may significantly reduce the amount of assets the donor can pass on free of estate tax. By reducing the value of the gifted ownership interest through discounting, the individual is able to pass more assets to his or her heirs at death.

Family business action groups are assembling a task force to fight the proposed regulations that would eliminate discounting. The IRS will hold a hearing on this proposed regulations on December 1, 2016, and the final regulations, if approved, could go into effect as soon as January 1, 2017.

If transferring an interest in a family business is of interest to you, in order to be assured that you can take advantage of the current \$5.45 million federal estate tax exemption and discounting, you may want to act by the end of the year. We are available to discuss currently available planning techniques that can protect family assets and pass them on to the next generation.