

**Using Gifts of Closely-Held Stock and Minority Interest Discounts  
to Minimize Federal Transfer Taxes on Family Owned Businesses**

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***Introduction***

The founder of a successful business often hopes to create a family legacy through the business and that future generations will own, manage and profit from the family business. Family business succession planning involves many factors. These include consideration of tax consequences, determination of control over the business after the retirement or death of the founder, and providing inheritances for those children or descendants who are not involved in the business so that they are treated equitably relative to those of their siblings or cousins who are active and will succeed to the business' equity and control.

Without thoughtful lifetime planning, the transfer of ownership of a family business to younger generations almost always will generate significant gift or estate tax liabilities (or both) and disharmony among family values. Planning that focuses primarily or exclusively on deathtime dispositions of property and providing liquid assets to pay the estate tax is a passive approach to succession that often falls short of these marks. Other equally important strategies include lifetime planning through irrevocable gifts that can "leverage" gift and estate tax exemptions and minimize the ultimate tax liability. These techniques also look beyond the senior generation to structure proper management and distribution to family members to avoid future federal transfer taxes upon their deaths through "generation-skipping" trusts.

The succession plan utilized by a particular business owner will depend upon many factors. These include the type of business involved, the owner's willingness to surrender control over the business during his or her lifetime, the degree of control the owner is willing to give to successive generations during his or her lifetime, the owner's tolerance for risk, and the net economic benefit of any particular strategy. The purpose of this memorandum is to aid the business owner and his or her family in understanding some common alternative structures, as well as the risks and benefits associated with each.

## *The Federal Wealth Transfer Tax System*

1. Application of the Transfer Taxes. The federal transfer taxes include the gift, estate and generation-skipping transfer taxes. They are called “transfer” taxes because they impose an excise tax on the privilege of transferring wealth. For 2010 and thereafter, the tax is assessed on the amount of wealth transferred and computed by applying a flat 40% tax rate to the total “fair market value” of property transferred by gift either during life or at death. The law provides several deductions and exemptions from transfer taxes.

2. Deductions and Exemptions from the Transfer Taxes.

a. The Marital Deduction. Transfers between spouses generally are exempt from the gift and estate tax as a result of the unlimited “marital deduction”. This deduction allows spouses to transfer property, including closely-held stock, between themselves during life without incurring a gift tax liability or filing a gift tax return. The deduction also allows property to pass upon death from a decedent spouse to the surviving spouse without generating a federal estate tax liability. Leaving all of your property to your surviving spouse often is not, however, the most tax-efficient planning strategy. This is so because the marital deduction merely defers, rather than eliminates, estate taxes. Generally, using the marital deduction in combination with transfers sheltered from tax by the unified credit exemption and gift tax annual exclusion amounts described in the following subparagraphs b. and c. is the most effective method of minimizing transfer taxes for wealthy business-owning families.

b. The \$5 million Gift and Estate Tax “Unified Credit” Exclusion Amount. The law allows each individual to transfer up to \$5 million to any person without incurring a gift or estate tax.<sup>1</sup> For married couples, as of 2012, any exclusion amount of a deceased spouse that was unused by that spouse’s lifetime and deathtime transfers will be “ported” to the surviving spouse. This is referred to as the “deceased spouse’s unused exclusion amount”, or “DSUEA”. For many couples of relatively modest wealth, this has eliminated the need under prior law to use a “credit shelter trust” and the splitting of assets between the spouses to ensure that no exemption amount is lost in the first spouse’s death.

However, many married couples with total wealth greater than \$6 million, particularly those with ultra-high net worths, are often still best advised to use credit shelter trust planning and not rely on the DSUEA portability. Relying on portability will forfeit opportunities for “generation-skipping” and much of the valuation discounting advantages of passing on minority interests in the business that are discussed later in this paper that can be so critical to the success of multigenerational wealth transfer tax sheltering.

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<sup>1</sup> This base amount established in the year 2010 is indexed by inflation and the increases through 2014 brought the amount to \$5.34 million.

c. The \$10,000 Gift Tax “Annual Exclusion”. The law also allows each individual to make annual gifts of up to \$10,000 per donee (\$14,000 in 2014 based on inflation adjustments) without consuming any of the individual’s \$5 million exclusion or paying a gift tax. A married couple can transfer double the exclusion amount per year to each of their descendants (or any other donees) gift tax free. For example, if a couple has three children and six grandchildren, in 2014 they can gift a total of \$252,000 (*i.e.*, \$14,000 x 2 donors x 9 descendants) each year gift tax free and remove the gifted property from their taxable estates.

### ***Estate Planning for Closely-Held Stock***

1. The Nature of Equity Interests in Private Enterprises. For most family business owners, the business assets -- generally the stock and any real estate used in connection with the operation of the business -- will comprise the majority of the value of the owner’s estate. If the owner dies owning all or a majority interest of the business, the full fair market value of the business, and possibly a “control premium”, will be included in the owner’s estate for estate tax purposes. The business owner can avoid this result by making irrevocable gifts of minority (*i.e.*, non-controlling) blocks of stock during his lifetime. Under New Hampshire law, any gifted stock representing less than 50% of the outstanding voting stock of a corporation is considered to be a minority interest, as a 50% shareholder can vote his or her shares to deadlock the corporation if the other shareholders do not agree. A shareholder who owns 51% or more of the voting stock occupies an even greater position of control. Arranging for the transfers of minority, and not controlling, blocks of the stock of the family corporation will make available the valuation discounts described later in this paper. A minority shareholder of a private New Hampshire corporation has limited legal defense against oppression at the hands of a controlling shareholder.

#### 2. Advantages of Lifetime Gifts of Closely-Held Stock.

a. Value Freezing and Wealth Shifting. The estate tax imposed on an interest in property is based on the fair market value of that interest at the moment of the owner’s death. If the same property is gifted during the owner’s lifetime, rather than transferred at death, appreciation on the property will accrue to the donee and escape estate and gift taxation. This is what is meant by the “value freezing” and “wealth shifting” benefits of lifetime gifts.

For example, assume that an individual owns 100% of a family business valued at \$10 million in 2014. By 2025, the year of the owner’s death, the value of the business is expected to double to \$20 million. If the owner transfers the business to his children in 2014, the entire \$10 million in appreciation will be removed from the owner’s estate for estate tax purposes. If the owner does not, however, the \$10 million in future growth will be subject to taxation at a rate of 40% (assuming the estate tax rates remain constant). Waiting 11 years will cost the family \$4 million – 20% of the total value of the business!

b. Hedging Against Tax Reform. Congress is always looking for ways to finance government initiatives and eliminate the budget deficit. The gift and estate tax is a particularly inviting target for reform-minded legislators. It may be more attractive politically for a future Congress to tax transfers of wealth than to levy additional taxes on income. Reform proposals that would reduce the \$5 million exemption, reduce or eliminate the \$10,000 annual exclusion and increase the transfer tax rate are perennials on Capitol Hill. Acting now should preserve the benefits of the existing system while they are still available.

c. Obtaining Minority and Marketability Discounts on the Value of Gifts of Closely-Held Stock.

(1) Determining the Value of Fair Market and Transfer Tax Values. The gift or estate tax value of a transferred business interest is its “fair market value” on the date of the gift or death. Fair market value means the price at which the property would change hands between a hypothetical willing buyer and a hypothetical willing seller, neither acting under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. This value is easy to determine for publicly traded companies. Such companies are required to have annual audited financial statements and to file detailed quarterly and annual reports with the Securities Exchange Commission. Brokerage houses spend substantial amounts of time determining the value of public companies. The daily stock page in the business section of a newspaper provides the market’s perception of the value of a publicly traded company. Because buyers and sellers have equal access to the relevant information about public companies, publicly traded stock is freely tradable at a moment’s notice at its full fair market value.

On the other hand, it often is very difficult to establish the value of a closely-held company. Although financial statements and tax returns generally are available, the financial statements often are not audited and the owners of the company may have goals and objectives other than maximizing the company’s income. There is no published source of actual sales of closely-held companies. There are often no actual arm’s length sales in the normal course of business within a reasonable time before or after the valuation date to serve as the measure of market value. The marketing and sale of a closely-held business requires tremendous effort on the part of the business owner. In most cases there is an extended period of due diligence and negotiations during which the buyer and seller exchange information about the company and attempt to reach a mutually satisfactory price.

In the absence of arm’s length “comparable” sales, the value of closely-held stock is determined by a professional appraisal that takes into consideration the company’s net worth, prospective earning power, dividend-paying capacity, and other relevant factors. They include the goodwill of the business, the economic outlook of the particular industry, the company’s position in the industry, the company’s management, the degree of the control of the business represented by the block of stock to be valued and the values of securities of corporations engaged in the same or similar lines of business and which are listed on a stock exchange. The weight given to these factors in the determination of value depends on the facts of a particular case. Valuation is a question of

judgment rather than mathematical precision. The difference between a taxpayer's valuation, professional's opinion and the IRS' estimation of value is often substantial. Such differences underscore the necessity of a qualified appraisal of a business' value (qualified appraisals are discussed in detail in Paragraph (4) below).

(2) Determining the Minority and Marketability Discounts. The determination of fair market value of shares of stock is only the first step. As important is the determination of whether, and to what extent, discounts for minority interests and lack of marketability apply. The minority interest discount applies in the case of a block of shares where the shareholder cannot control corporate policy, the payment of dividends or the selling of assets in order to obtain value from his or her stock. The lack of marketability discount is imposed in recognition of the difficulty in finding the hypothetical willing buyer who, once he or she acquires "reasonable knowledge of the relevant facts," will still be willing to purchase the interest.

The exact amount of minority interest and marketability discounts in any given case is established by a business appraiser. The marketability discount is distinct from the minority interest discount, and may be available even when the minority interest discount is not. After years of denying them, the IRS recently began to accept these discounts in valuing intra-family gifts of stock in family owned corporations. Combined minority and marketability discounts for closely-held stock can be as high as 50%. A 35% combined discount is often used as a rule of thumb.

(3) Illustrations of Discounts. An example will illustrate these principles. Assume that a business owner owns 100% (100 shares) of the voting stock of his company. The undiscounted value of each share is \$100,000, for a total value of \$10 million. The owner's son, Junior, is also active in managing the business and is the heir apparent. If the owner is unmarried, holds all of the stock until his death and allows it to pass to Junior under the terms of his revocable trust (or will), and dies in 2014 not having used any of his \$5.34 million exemption amount by making lifetime gifts, the federal estate tax imposed on the deathtime transfer of the stock to Junior could be as much as \$4 million, if the owner's other assets have a value of at least \$5.34 million.

Now assume that instead of holding all of the stock until his death, in 2014 the owner gifts a 49% minority block during his lifetime to Junior (or, better yet, as described later, a generation-skipping trust created for Junior and his descendants). What would be the value of his gift for gift tax purposes? 49% of the value of the company as a going concern (*i.e.*, \$4.9 million)? No. The valuation would reflect the gifted block's lack of control and marketability. Assume that a qualified appraiser determines that the appropriate combined minority interest and marketability discount is 35% of \$4.9 million. \$1.715 million ( $\$4.9 \text{ million} \times 35\%$ ) of the business' value will simply disappear from the transfer tax system. This disappearing value will never be taxed. The gift tax value of the gifted block of stock would be \$65,000 per share, rather than \$100,000 per share, for a total value of \$3.185 million. That gift will be sheltered from gift taxation by a corresponding \$3.185 million portion of the owner's \$5.34 million exemption amount. At the flat estate tax rate of 40%, the outright gift produces tax savings of \$656,000 for Junior. That could make the difference between Junior successfully continuing the business and having to burden it with crippling debt to

pay estate taxes that could have been avoided if Dad had played his cards correctly.

(4) Necessity of a Business Appraisal. Because the use of minority interest and marketability discounts is essential to reducing the value of gifted stock and leveraging the use of the business owner's \$5.34 million exclusion, it is important that the value of the stock on the date of the gift, and any minority interest and marketability discounts, be supported by a credible professional appraisal. The appraiser's report should accompany the gift tax return on which the business owner reports the gifts of stock.

Obtaining a qualified business appraisal is crucial for two reasons. First, it supports the reported gift tax value and triggers a three year period during which the IRS must challenge the reported value or forever hold its peace. The benefit of this statute of limitations is only available if the donor makes "adequate disclosure" of the basis for the reported discounted value. Second, experience shows that the IRS is quick to audit gift and estate tax returns reporting transfers of stock in closely-held companies if there is any evidence that the taxpayer did not use due care in determining the value of the transferred stock. The IRS views valuation questions as battles it can win because each business valuation is fact specific. There are several valuation techniques which may or may not be appropriate in any given case. In many ways, valuation is really more art than science. The IRS has had considerable success over the years challenging unsupported or overaggressive valuations.

An unsupported valuation probably has a 100% chance of being rejected or challenged by the IRS right up until the donor of the gift dies no matter how long before his death that he made the gift. An informal opinion of value prepared by the corporation's in-house bookkeeper or accountant is much more likely than not to be challenged successfully. However an auditor is far less likely to challenge a professionally prepared appraisal prepared by a reputable, experienced business valuation professional who applies generally accepted appraisal techniques appropriate for the particular industry. This generally is true even when the appraisal establishes significant minority interest and marketability discounts as described above. Paying for a good appraisal increases the chances that the IRS will resolve this issue in the taxpayer's favor or never challenge the appraised values. Although getting an appraisal will be expensive -- generally anywhere from \$10,000 to \$20,000, depending on the appraisal firm chosen, the parameters drawn for it and the number of other professionals whose help must be enlisted -- the business owner can view this expense as the purchase of insurance against an expensive valuation controversy. In light of the significant tax savings generated by gifting discounted blocks of stock, it is money well spent.

### 3. Alternatives to Outright Gifts.

a. Drawbacks of Outright Gifts. As the examples above demonstrate, an outright gift of a minority block of stock provides significant transfer tax savings and also is relatively simple to execute and administer. However an outright gift also has several shortcomings. For example, it removes assets from the business owner's estate without providing the owner with anything (*e.g.*, an income stream) in return. It gives the donee unrestricted control over the gifted stock. An outright

gift also may cause immediate estate tax problems for the donee and his or her family. These problems eventually could prevent the donee's heirs from continuing the business or realizing its full economic value if they chose to sell it.

b. Making Gifts to an Irrevocable "Gifting" Trust. Instead of gifting a minority interest in the family business stock outright, the business owner could gift the stock to an irrevocable "gifting" trust. This trust achieves three important objectives.

(1) The Gifting Trust Is Federal Income Tax Efficient.

(a) The "Intentional" Grantor Trust Status Concept. An "intentional" grantor trust is a trust over which the trust creator (the "grantor") retains sufficient control over the trust property so that he or she is treated as its owner for federal income tax purposes, but not for federal transfer tax purposes. These controls could include the power to substitute other property for the stock the grantor originally transferred to the trust, and the power to borrow trust principal or income without adequate interest or security. As a result, during the grantor's lifetime, all of the trust's items of income, loss, deduction and credit would be reported on the grantor's (*i.e.*, business owner's) personal tax return, not the trust's separate return. This is significant in any year in which the trust has taxable income or deductible losses.

(b) Tax Consequences of Intentional Grantor Trust Status.

i) Taxes on Income. In any year in which the trust has taxable income, the grantor's payment of the federal income tax liability effectively will be a non-taxable gift to the trust. This allows the trust to enjoy compound growth without erosion by income taxes. It also allows the grantor to avoid the high income tax rates which apply to trusts generally. As long as the business owner retains control over the corporation, he can determine his own compensation, and ensure that he receives sufficient distributions from the corporation to pay his income tax liability.

ii) Using Tax Losses. If the family business sustains a loss in any tax year, the percentage of loss attributable to the stock owned by the trust will flow through to the grantor and be reported by him on his personal income tax return. Having these losses on the business owner's personal return will reduce his overall income tax liability.

(2) The Gifting Trust Preserves the Corporation's S Election.

(a) Legal Restrictions on Trusts as S Corporation Shareholders. "S" corporations must comply with strict requirements in order to preserve their S election and single level of taxation. When completing their estate planning, many unwary business owners and their advisers prepare a plan which inadvertently violates the S corporation rules and triggers the double level of taxation which applies to regular "C" corporations. The tax laws permit only three types of non-charitable trusts to hold S corporation stock: intentional grantor trusts, qualified subchapter S

trusts (QSSTs), and electing small business trusts (ESBTs).

(b) The Gifting Trust Is an Eligible S Corporation Shareholder.

i) During the Business Owner's Lifetime. During the business owner's lifetime, the gifting trust is an intentional grantor trust. These trusts are eligible S corporation shareholders.

ii) After the Business Owner's Death. Upon the business owner's death, the gifting trust most often will continue as an electing small business trust, or, if the requirements of an EBSST cannot be satisfied at that time, as a qualified subchapter S trust or "QSST".

(3) The Gifting Trust Allows for Generation-Skipping.

(a) Tax on Transfers between Generations. The estate tax applies to transfers of wealth between generations. A child who inherits estate taxable property from his or her parent will receive only what property remains after the payment of the estate tax. As that same property passes through successive generations, the entire value of the property eventually will be consumed by estate taxes or sold to pay the estate tax. Wealthy families have tried to avoid the consumption of their property by estate taxes by using generation skipping transfers. Because these transfers bypass a child's generation and advance directly to a grandchild, they avoid gift and estate taxation in the child's generation.

(b) Gifting to a Generation-Skipping Trust. By gifting a minority block of closely-held stock to a generation skipping trust (instead of outright to a grandchild), the business owner can give his children virtually all of the benefits of outright ownership of the stock without having it included in their estates for estate tax purposes. This would eliminate or significantly reduce the need for the children to engage in expensive or complicated estate planning. In addition, the trust would protect the stock from a child's creditors if, for example, the child filed for bankruptcy or divorce.

4. Approaches to Gifting Minority Interests in Closely-Held Stock. Once the business owner understands the mechanics of the transfer tax system and the tax savings available through gifts (either outright or in trust) during the owner's lifetime, he must decide how to structure lifetime gifts so that he minimizes gift and estate taxes yet fulfills his non-tax objectives -- for example, retaining control of the business in his generation during his lifetime, controlling the ultimate disposition of the stock, achieving financial security during the his and his spouse's lives, etc. The following two approaches both provide significant tax savings but different levels of risk and control during the owner's lifetime.



a. The Conservative Approach. The conservative approach involves the least sacrifice of control and the most access to equity during the business owner's lifetime. The business owner gifts 2% of his ownership interest outright to an irrevocable gifting trust for the benefit of his children and 49% to his spouse. The 49% interest transferred to the owner's spouse either could be gifted outright or to a lifetime ("inter vivos") qualified terminable interest property (QTIP) trust.<sup>2</sup> A QTIP trust would be used if the business owner wants to remove the stock from his estate without giving his spouse total access to the stock during her lifetime or control over its disposition upon her death.

The advantages of this approach are that it retains the equity of the business, and any proceeds from a future sale, in the business owner's generation. The business owner and his spouse collectively retain control of the business during their lifetimes. Because neither the owner nor his spouse owns a controlling interest, a minority interest discount would apply to the stock included in either spouse's estate and the application of a control premium is avoided.

A drawback is that the business owner and his spouse must plan for the disposition of a large amount of stock upon the first of their deaths. The business owner must determine whether his stock should pass to the surviving spouse upon his death if he predeceases her. This may be acceptable if the business owner is confident that the spouse will dispose of the stock in a manner consistent with the owner's wishes. If not, or if the owner wants complete certainty regarding the eventual disposition of the stock, he can direct that upon his death his stock be transferred to a "credit shelter trust" for the benefit of the surviving spouse and her descendants. The credit shelter trust generally holds property equal in value to the remaining amount of the decedent's gift and estate tax exclusion amount (again, \$5.34 million in 2014). The property in the trust does not qualify for the marital deduction, but will not be included in the surviving spouse's estate. To the extent the value of the stock transferred to the credit shelter trust exceeds the donor's exclusion amount, there will be an estate tax due upon the first spouse's death.

A more aggressive approach can eliminate this tax on the first death. The business owner can direct that upon his death his stock be transferred to a QTIP trust. The property in the QTIP trust qualifies for the marital deduction, and allows the decedent's exclusion amount to be applied to other estate taxable property. As with the inter vivos QTIP trust, the stock would be held for the surviving spouse's benefit. She would not control distributions of trust property during her lifetime or the distribution of the stock after her death. Upon the surviving spouse's death, the QTIP property will be included in her estate but not aggregated with the stock owned in her individual name. Therefore a control premium will not increase the value of stock included in the survivor's estate. Instead, minority interest discounts will apply to the stock in the QTIP trust and the stock owned in the surviving spouse's individual name.

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<sup>2</sup> An inter vivos QTIP trust gives the spouse the benefit of the trust property during her lifetime, and may reserve a secondary life estate in the trust property for the business owner if his spouse predeceases him. The QTIP trust has no gift or estate tax consequences if the donor spouse dies first or does not retain any interest in the trust property.

Another risk associated with gifting only 2% of the stock outright to or in trust for the owner's children during his life is that in the future the IRS may successfully lobby to limit or eliminate minority and marketability discounts on intra-family transfers. The President's budget proposals have included such a provision in each of the last several years. Making transfers now before any changes are made to the valuation rules will lock in the benefits of discounting for at least the interests transferred.

b. A More Aggressive Approach. The more aggressive approach reduces the taxable estate of the survivor of the business owner and spouse and the estate tax liability that will be due upon his or her death. The business owner irrevocably transfers 49% of his stock to his children or a gifting trust during his lifetime. This allows the owner to take advantage of intra-family minority discounts while they are still available and to freeze the transfer tax value of the gifted property at its date of transfer values. Future appreciation on the property will accrue to future generations. The owner transfers an additional 2% interest to his spouse, either outright or in trust (an inter vivos QTIP).

In addition to the tax reduction benefits, this approach presents less of a planning challenge on the first spouse's death. If the spouse owning 2% of the stock dies first, there most likely will be no estate tax due, even if all of the stock is transferred to a credit shelter trust. If the spouse owning 49% of the stock dies first, the stock can be transferred to a credit shelter trust. If the value of the 49% interest exceeds the amount of the decedent's remaining estate tax exclusion amount, an estate tax will be due. This result can be avoided by transferring the excess value outright to the surviving spouse or to a QTIP trust.

A drawback to this approach is that if the business is sold in the future, 49% of the sale proceeds will accrue to the benefit of the children or the gifting trust. However, if the spouse is a beneficiary of the gifting trust, access to the proceeds can be maintained in the senior generation.

### ***Other Estate Planning Strategies***

Other important factors to consider when developing a family business succession plan include the following:

1. ***Ensuring that the surviving spouse's estate has sufficient liquid assets with which to pay the estate tax liability.*** Often this goal can be achieved through the purchase of life insurance. If the policy is owned by an irrevocable trust over which the grantor or his spouse retains no control or beneficial interests, the proceeds will not be included in their estates and will be available in their entirety to provide liquidity to the surviving spouse's estate through asset purchases or loans.

2. ***Equalizing the inheritance of children not involved in the family business.*** Equalization can be achieved by earmarking insurance proceeds for the uninvolved children, or by deeming lifetime gifts of stock as "advancements" against the inheritances of children who succeed

to the ownership of the business.

3.     ***Avoiding probate.*** Transferring all of your assets into revocable trusts during your lifetimes will remove them from the probate process and minimize the time and expense of administering your estates.