The Window Could be Closing!

Don’t miss the opportunity to get a bigger valuation discount for your business

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Most business owners have goals for the future of their company after they retire. Those goals may include selling out to a private buyer, or handing the company over to a child or employee.

When a business owner plans to hand the reins over to an heir or sell it, having the business consist of a majority of the family estate can cause large estate tax issues. Reducing the value of the business for tax purposes can have an enormous impact on the wealth that a family retains when a business is sold or passed on to the next generation. Changes are being proposed by the U.S. Treasury that can affect how business owners reduce their business values for estate planning purposes.

Challenges of S Corporations

For a variety of reasons, the preponderance of businesses are formed as S corporations or “pass through” entities due to the benefits of flow-through taxation to the owners. Although this flow-through taxation can be very beneficial to the owners, there are several restrictions that come from this S corporation status. The biggest of which is that the basic structure lacks the separation of preferred and common interests, which allow control and ownership to be separated. This ability is essential to effective business succession and estate planning. The answer – recapitalization!

Recapitalization of the S Corporation Stock

A recapitalization of the S-corp stock allows existing stockholders to start transferring the business to the next generation without abdicating control, and gives the new shareholders an incentive to grow the business. Recapitalizing shares is a non-taxable event.

During the recapitalization process, typically the control and management interest (voting shares) of the business is held by the original business owner and family members who are active in the company so they can continue managing the business until it is successfully passed on to another person or entity via transfer or sale. Those shares will continue to stay within the family estate.

The valuation of the non-voting shares or equity ownership interest of the master holding company can be gifted or sold to a grantor irrevocable trust to remove any future growth of the company from being included in the estate. Because these are non-voting shares, they can be discounted for lack of control and marketability purposes, reducing the amount of gift taxes owed on their transition into the trust.

Time is of the Essence!

The U.S. Treasury issued a statement on Aug. 2, 2016*, indicating it will seek changes to discounting rule 2704, removing the ability for families with operating businesses and for companies that hold passive investment assets from being able to claim this discount. This would likely result in a substantial increase in estate taxes if it were to pass. Changes are projected to go into effect in January, 2017.
Because of this narrow window of time, business owners should review their business planning strategy with their tax and legal advisors to determine if discounting would be a benefit to the overall family estate, and if so, to take advantage of the rules before the proposed changes may go into effect. Missing this window may result in a substantial loss of your ability to discount the value of your business. We’ve seen examples where as much as 40 percent of this discount was lost. Time is a significant factor as qualified attorneys are very busy as year-end approaches, so make your appointment as soon as possible!

* The overall effect of section 2704(b) is that specified restrictions are disregarded in valuing such an interest for gift or estate tax purposes when that interest is transferred to a family member or family-controlled entity that are subject to restrictions on redemption or liquidation

The proposed regulations would also make significant changes to the valuation for transfer tax purposes of interests in a family-controlled entity that are subject to restrictions on redemption or liquidation

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