

## THE PRESERVATION OF FAMILY BUSINESS WEALTH

By Marcel J. Bernier and Natale A. Messina

DECEMBER 2016

For questions about any matters involving estate planning issues, please contact:

Richard A. Marone, Chair  
Marcel J. Bernier  
Alfred R. Casella  
Shera G. Golder  
Robert A. Heinimann, Jr.  
Natale A. Messina  
Lisa Newfield  
Irving S. Schloss  
Lisa P. Staron  
Suzanne Brown Walsh

Boston:  
617.457.4000

Hartford:  
860.240.6000

New Haven:  
203.772.7700

Stamford:  
203.653.5400

White Plains:  
914.682.2053

Woburn:  
781.933.5505

It is often the case that a business owner has a significant portion of the family's wealth invested in the business. It is often the intention of the owner to transfer that wealth to his or her children. This intention is complicated by the fact that some of the children may be active in the business and others may not be active in the business. There is also the issue of the state and federal government's desire to share in the transfer of the wealth related to that business. This article will explore the methodology for transferring wealth in a way that maintains family harmony as well as minimizes the taxation of that wealth by the taxing authorities.

**Transfer Options.** Transfers of business interests during the life of a parent to one or more children can occur by either gift or by sale. The choice of gift versus sale is a function of the parent's need for cash flow and the children's and the business's ability to pay. If the parent has other sources of income, then a gift will accomplish the transfer. Further, there will be no additional distributions related to the transferred business interest that will serve to increase the size of the parent's estate. If there is a need by the parent for additional cash flow, then the parent must either retain a continuing working relationship with the business or contemplate a sale. A continuing working relationship would be in the form of either an employment agreement, or consulting arrangement. A sale will usually involve payment in the form of a promissory note providing for a series of payments. The amount and number of payments will often be based on what is affordable considering the expected after-tax cash flow of the business.

If some children are active in the business and others are not, then the parent will likely want to consider equalization of inheritances. Either a non-voting business interest or nonbusiness assets of equivalent value can be transferred to the children who are not active in the business. If a sale of the business interests is at fair value, then equalizing transfers to the children who are not active will not be necessary because the sale has no gift element.

**The Tax Implications of a Transfer.** There are potential federal and state estate and gift tax implications associated with lifetime gifts and transfers at death. A transferor can gift \$14,000 annually to each transferee without federal gift tax implications. (The same rule applies for Connecticut gift tax purposes. Neither New York nor Massachusetts has a gift tax.) Gifts per transferee in excess of that amount can be offset by the 2017 federal exclusion of \$5,490,000 and the state exclusion, for Connecticut purposes, of \$2,000,000. The key to effective use of annual and lifetime exclusions is value leverage. This leverage is accomplished by gifting interests that qualify for valuation discounts. Discounts for lack of marketability (meaning there is no recognized market for sale of the interest) and minority interest (meaning the interest does not carry majority voting control of the entity) are both possible. The combination of these discounts can be in the range of 25-40%. With these discounts, a considerably larger business interest can be transferred at a lower estate and gift tax value. This can significantly reduce or eliminate an owner's federal and state estate and gift taxes.

A sale of a business interest is a capital transaction and may generate a taxable capital gain equal to the amount of the sale proceeds reduced by the seller's basis. If marketability and minority interest discounts are applicable to the value of the sold interest, then the tax on the sale will be reduced. If the discounts used in valuing the business interests are excessive, the taxing authorities may argue that the transaction was actually a part sale and part gift and assess the associated gift tax.

**The Potential Savings.** The 2017 federal exemption is quite generous (\$5,490,000 per individual and \$10,980,000 per couple). If the value of the estate transferable to children or other beneficiaries exceeds that amount, the federal estate tax rate applicable to the excess is 40%. Further, the state estate tax top rates can be as high as 12% (CT) or 16% (NY and MA). Accordingly, every dollar transferred on a tax leveraged basis during the life of the parent is actually worth a dollar while a testamentary transfer after the death of a parent may only be worth approximately half that.

**Refining the Sale and Gift Strategies.** The benefits of a sale or gift transaction can be further refined depending on the family circumstances. If the family situation requires that business decision-making must be retained by the transferor parent, then the use of voting and non-voting interests can be incorporated. A non-voting interest can be transferred by a parent to a child to allow for estate reduction without the risk of interference with decision making. If administrative control of the asset or protection from creditors or spouses is important, then the utilization of a trust for the benefit of children as the recipient can be employed. A sale to a grantor trust and a gift to a grantor retained annuity trust are two additional strategies incorporating trusts and offering additional tax leverage benefits. A detailed analysis of these strategies is beyond the scope of this article but can be discussed with your Murtha Cullina attorney.

**The Internal Revenue Service's Response.** In an effort to counter these leveraging strategies, the Internal Revenue Service crafted proposed regulations under Internal Revenue Code Section 2704. These proposed regulations, which are currently the subject of public hearings, appear to eliminate the use of discounts when determining the value of a business interest transferred to family members. If the Service is successful in implementing these regulations, the potential effective date is important. Transfers prior to the effective date can use existing valuation discount rules. Transfers after the effective date perhaps may not. Accordingly, if a business is a significant portion of a family's wealth and there is a desire for preservation of that wealth, gifts of business interests should be considered before the proposed regulations become effective. Please contact your Murtha Cullina attorney if you would like more information.

*For questions or more information, please contact:*

*Marcel J. Bernier at 860.240.6087 or [mbernier@murthalaw.com](mailto:mbernier@murthalaw.com)*

*Natale A. Messina at 860.240.6027 or [nmessina@murthalaw.com](mailto:nmessina@murthalaw.com)*