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4 Reasons Why Now is the Best Time to Gift a Closely Held Business

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Gifting of stock in a closely held business is often a good technique in transferring assets out of someone's estate if they are concerned it will be subject to estate taxes in the future. Gifting when the value of the stock is at a low maximizes the benefit of gifting. Future uncertainty causes stock values to decrease, so now is a great time to consider a gifting plan!

Let's dig into the opportunities and what we can discuss with our clients.

1. COVID-19 means there's never been a better time to keep company growth out of the estate

When an estate gets close to taxable estate limits, a good tax-planning strategy is to keep the growth of the business out of the estate — and thus reduce estate taxes. Any growth in a company's value after the date of the gift stays out of the estate.

Gifting to children right now is especially ideal because the COVID-19 pandemic has driven down the value of many companies. And it's done so in four different ways:

1. Businesses are seeing lower actual or projected revenue due to the pandemic's impact, which drives down value.
2. Businesses have increased their interest-bearing debt in order to pay employees and other fixed expenses, and debt reduces a company's value.
3. Businesses have seen a decrease in the value of tangible assets such as inventory, machinery, equipment and real property due to changes in market demand and occupancy rates.
4. Businesses have seen value decrease because of lack of control and lack of marketability discounts due to liquidity issues in the market.

There are three benefits to gifting when the business's value is lower. One, less of the total estate exemption will be used, and that will allow other assets to be transferred without tax implications. Two, more of the business can be gifted without tax impact. And three, the COVID-19 pandemic is not going to last forever, and business values will rebound, so by gifting now, the value appreciation is out of the estate.

2. Potential changes to the lifetime exemption

Under current U.S. tax laws, the lifetime gift exemption is $11.58 million for an individual. A married couple have a combined lifetime exemption of $23.16 million. The current lifetime exemption is set to decrease in 2026. Given how low tax rates are and how high exemptions are right now, we're almost guaranteed to see changes at any time. There is uncertainty of when changes may happen but with the president, senate and house of the same party it is more likely to happen in the future then at any other time. By acting now, we can assist our client in taking advantage of low tax rates and high exemptions while they still can.

It's also important to be aware that Congress and future presidents could limit the discounting strategy we discuss below in section #4. A proposed IRC 2704 regulation would have limited discounting options, but it was stopped with the 2016 change in U.S. presidents. The idea of limiting discounting could arise again. This is yet another reason to act now while things are still certain.

3. The annual gift tax exemption is $15,000 per person and doesn't count toward your lifetime exemption

As of 2020, an individual can give up to $15,000 per year to one or more people. If married, a combined $30,000 can be gifted to one individual. Annual gifts that qualify under this gift-tax exclusion do not reduce the lifetime estate or gift tax exemptions.

For example, parents with four children could transfer interest in their business that totals $120,000 ($30,000 X 4) this year without reducing the $11.58 million lifetime exemption. With the discounting discussed in section #4 below, the $120,000 represents a much larger value to the children. For example, at a 30% discount rate, the $120,000 will really represent $171,429 rounded ($120,000/70%).

The disadvantage of gifting the annual exemption amount each year is that the growth of the business remains in the estate. But if the company value is small, this may be a good approach to consider.

4. The discounts for lack of control and lack of marketability allow more assets to be transferred out of the estate

When a privately held company is sold or gifted, the value of the company may be reduced by the lack of control and lack of marketability discounts. These discounts are due to 1) the inability of a minority shareholder to sell their stock and 2) the lower price someone would pay for that stock if they don't have control of the business.

With these discounts, more stock can be transferred to children under the gifting limits and more assets will be out of the estate. It is better to transfer a minority interest in a company than to transfer undiscounted cash.

Discounts for lack of control and marketability are dependent on many variables but can range from 10% to 25% each.

By taking advantage of the discount for lack of control and discount for lack of marketability, plus the annual donee exclusion, with the spouse, there can be sizable estate and gift tax savings.

Example of the opportunity in action

Let's say, for example, that Mr. and Mrs. Smith own a 100% interest in a closely held business. In 2020 the company operations were impacted and there was a drop in value, which was followed by a rebound in 2021 and 2022.

Using an estimated 15% minority discount and a 20% marketability discount, you can see the impact in gifting a closely held minority interest. In 2020 by taking advantage of the minority and marketability discounts, there is a savings in the use of the lifetime exemption of $4,800,000. Additionally, by gifting when the company value is down, there is a savings of $1,600,000 from the 2021 value and $2,560,000 from the 2022 value. Clearly, the biggest impact in the use of the lifetime exemption is gifting when the company value is down and when the discounting options are still available.

ABC Company				
Gifting Scenario				
		2020	2021	2022
Value of ABC's Equity on a Controlling, Marketable Basis		$ 15,000,000	$ 20,000,000	$ 23,000,000
Minority Discount	15%	2,250,000	3,000,000	3,450,000
Conclued value of Equity on a Minority, Marketable Basis		12,750,000	17,000,000	19,550,000
Marketability Discount	20%	2,550,000	3,400,000	3,910,000
Conclued value of Equity on a Minority, Nonmarketable Basis		$ 10,200,000	$ 13,600,000	$ 15,640,000
Gift 25% each to 4 children	(1)	10,200,000	13,600,000	15,640,000
Combined Annual Gift - 4 children	(2)	120,000	120,000	120,000
Use of Lifetime Exemption with discounts		$ 10,080,000	$ 13,480,000	$ 15,520,000
Gift of 25% to 4 children without discounts		15,000,000	20,000,000	23,000,000
Combined Annual Gift - 4 children	(2)	120,000	120,000	120,000
Use of combined Lifetime Exemption w/o discounts	(3)	14,880,000	19,880,000	22,880,000
Use of Lifetime Exemption without discounts		14,880,000	19,880,000	22,880,000
Use of Lifetime Exemption with discounts		10,080,000	13,480,000	15,520,000
Benefit of discounts on Lifetime Exemption		$ 4,800,000	$ 6,400,000	$ 7,360,000

(1) A 25% interest is a minority interest and in total 100% of the company value is gifted
(2) $15,000 per individual - $30,000 each for 4 children = $120,000 - assumed no change in future years
(2) Mr. and Mrs. Smith don't exceed the joint lifetime exemption of $23.16 million

Hire a qualified business valuation appraiser

One of the requirements of the IRS is hiring a qualified appraiser. It is important that the appraiser has earned an appraisal designation from a recognized professional appraisal organization (such as the ASA, NACVA, IBA, or AICPA). Engaging the right specialist in business valuation is important. Qualified appraisers include a certified public accountant (CPA) accredited in business valuations (ABV), a certified business appraiser (CBA), certified valuation analyst (CVA) or an accredited senior appraiser (ASA).

Conclusion

Now is the time to transfer family wealth when business values are down and tax exemptions are high. Once the impact of the COVID-19 pandemic comes to an end and the economy begins to improve more and more, company values will increase. Start discussions with your clients on this great tax-planning opportunity. This could be the best time to gift stock in a closely held company.

Audra Moncur, CPA/ABV leads Wipfli’s valuation services group in Illinois and works with clients and attorneys to provide business appraisal services for the purposes of litigation support, buying or selling businesses, divorce, and estate planning or gifting.