**8822. What gift tax concerns apply in the family business context when planning for business succession?**

In many cases, the retiring business owner in a family owned small business will want to transition the business to the owner’s children using a gifting strategy, rather than a traditional sale. Because the American Taxpayer Relief Act increased the top estate and gift tax rate to 40 percent for tax years beginning after 2012, avoiding this tax will often be a top priority for small business owners.[[1]](#footnote-1)

Each taxpayer is allowed to exclude $5.34 million (in 2014, as indexed for inflation) from transfer taxation during the taxpayer’s lifetime (gifts made during life and post-mortem are aggregated for purposes of determining the exempted amount).[[2]](#footnote-2) Further, a $14,000 (in 2013 and 2014, up from $13,000 for 2011 and 2012) annual exclusion is available for present interest gifts on a per donor/donee basis.

Establishing value for purposes of the exemption and exclusion amounts will be a primary concern for many exiting business owners because, in the small business context, there is often no established market value for the interests being transferred. In the context of the family owned business, the transfer of business interests from one generation to the next is often not accomplished as a result of arm’s length negotiations that result in a purchase price that reflects any actual market value of the company.

Thus, when a business owner transfers his ownership interests, a valuation will be required to determine the worth of company shares and the applicable amount of taxes upon the transfer of those shares. Often, however, the lack of established market makes it difficult to accurately determine the value of the transferred interests, opening the business owner to IRS’ challenge and potential future gift tax liability for undervalued shares.

 *Wandry vs. Commissioner* was a case where taxpayers were able to establish the value of business interests that were transferred to their children in terms of a dollar value which reflects a specific percentage interest in the entity. By defining the gift in terms of a dollar value of a partnership interest, the amount of the gift could be capped at the annual exclusion amount, (or other specific dollar amount) rather than specifying a percentage or number of interests subject to transfer. Because the value of the business had not yet been ascertained, the taxpayers specified that the gifts were not to exceed the annual exclusion amount in the documents governing the transfers of the business interests. The taxpayers used their existing gift tax exemption in making the gifts. In *Wandry*, the court approved a formula gift clause that viewed the gift as being of a fixed dollar amount with this fixed dollar amount being expressed as a percentage of the business value. To the extent that the valuation was not correct, the gifted interests were reallocated among the owners of the business. Part of the significance of the case is that the court noted that with respect to the reallocation of the partnership interests, it did not matter if some of the reallocated interests went back to the grantor.

Outright gifts are not the only type of transaction that can give rise to gift tax concerns in the family business context, however. Shareholders of nonparticipating preferred stock in profitable family held corporations have been held to have made gifts to the common stockholders (typically descendants of the preferred shareholder) by waiving payment of dividends or simply by failing to exercise conversion rights or other options available to a preferred stockholder to preserve his position.[[3]](#footnote-3) The Tax Court has held that the failure to convert noncumulative preferred stock to cumulative preferred stock did not give rise to a gift, but that thereafter a gift was made each time a dividend would have accumulated. However, the failure to exercise a put option at par plus accumulated dividends plus interest was not treated as a gift of foregone interest.[[4]](#footnote-4)

A transaction involving the nonexercise of an option by a son under a cross-purchase buy-sell agreement followed by the sale of the same stock by the father to a third party when the fair market value of the stock was substantially higher than the option price was treated as a gift from the son to the father.[[5]](#footnote-5) Also, a father indirectly made a gift to his son to the extent that the fair market value of stock exceeded its redemption price when the father failed to exercise his right under a buy-sell agreement to have a corporation redeem all of the available shares held by his brother-in-law’s estate and the stock passed to the son. [[6]](#footnote-6).

1. . American Taxpayer Relief Act of 2012, Pub. Law No. 112-240, Sec. 101. [↑](#footnote-ref-1)
2. . Rev. Proc. 2013-35, 2013-47 IRB 537. [↑](#footnote-ref-2)
3. . TAMs 8723007, 8726005. [↑](#footnote-ref-3)
4. . *Snyder v. Comm.*, 93 TC 529 (1989). [↑](#footnote-ref-4)
5. . Let. Rul. 9117035. [↑](#footnote-ref-5)
6. . TAM 9315005. [↑](#footnote-ref-6)