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FLLC Valuation Discount Gift Planning in 2020

The estate and gift tax rules have been pulled into the political whirlpool of proposed tax code modifications following Joe Biden's anticipated victory in the 2020 Presidential Election. Should the remaining open Senate seats flip to Democratic control, there is speculation that a Democratic controlled legislature would modify or accelerate the expiration of the TCJA increased estate tax exclusion amount. The window to make tax-advantaged gifts under existing more favorable tax provisions may, as a result, be closing quickly.

Biden's proposed tax plan may result in a significant decrease in the federal estate tax exclusion (and, by relation, the lifetime gift tax exclusion). Presently, the federal estate tax exclusion is $11.58 million per individual in 2020 (spousal portability matters aside). This exclusion may at some point decrease to, for example, the much lower $5.49 million exclusion per individual – a familiar amount which was the exclusion value in place prior to the 2017 TCJA changes. Other Democrat proposals include lowering the exclusion to $3.5 million and raising the rate to 45%. Due to the political uncertainty surrounding federal estate tax provisions and the unresolved matter of how and whether there will be any retroactive "clawback" provisions relating to historical gifts under higher exclusion years baked into such changes, year-end gift planning has moved into focus for many individuals and their estate planners.

One popular and tax-advantaged method of making significant gifts involves the use of a Family LLC (one type of family holding company). By transferring assets to fund a properly structured and properly operating FLLC, a taxpayer can then subsequently transfer less-than-majority portions of his or her interest in the funded FLLC to beneficiaries or to trusts for the benefit of those beneficiaries. Upon irrevocable transfer of an interest in the FLLC, provided that the transaction is properly structured, the taxpayer is deemed to have made a "completed gift" of that portion of his or her interest. Once the gift is complete, the transferred assets (the underlying value of the FLLC which he or she funded) are no longer considered a part of the taxpayer's gross estate (although the value of the gift will still be included on the date it is transferred), meaning that any future appreciation on those assets will no longer have any impact on the taxpayer. Beyond the lifetime gift exclusion, additional gifted property in excess of such exclusion may result in a gift tax liability; however, the upfront cost of a taxable gift may be balanced by virtue of the concept of "valuation discounting."

Valuation discounting is the important accompanying tax incentive for using an FLLC in a gifting strategy. Since the taxpayer has transferred a relatively illiquid, less-than-majority interest in the FLLC, he or she may be able to "discount" the valuation of the gifted interest for tax purposes, thereby treating the tax value of the gift at a value which is smaller than the fair market value of the underlying assets for the membership interest transferred. Two key factors determine the application of valuation discounts, namely, whether the transferred FLLC interest (i) conveys a minority interest in the FLLC which does not give the recipient a controlling ownership interest in the LLC (hence, a "lack of ownership control" discount), and/or (ii) the underlying LLC interest is not readily marketable, meaning that the FLLC interest is not considered readily marketable to a potential investor in the open market (hence, a "lack of marketability" discount).

For example, if you were to make a gift to a family member of a small interest in a properly structured FLLC which had a *fair market value* of $1,000,000, application of the above discounts might reduce the *gift tax value* of this gift to, hypothetically, $700,000 – a substantial difference! This is ultimately the tax value of the gift, whether that value is a use of your lifetime gift tax exclusion applied to this gift, or a taxable gift beyond the exclusion. Valuation discounts allow a taxpayer to facilitate the transfer of wealth in a favorable or “tax advantaged” way. There are a variety of other benefits which may also accompany FLLC estate planning, such as a layer of asset protection from creditors, which are beyond the scope of this post.

Proper utilization of gifting discounts is often a key component of the advanced gift planning strategies within a client’s estate plan. However, there are numerous requirements which must be satisfied for the FLLC arrangement to be considered legitimate by the IRS, all of which may be met with proper planning by competent counsel.

If tax-efficient wealth transfer is an objective of yours, particularly in light of the possible changes to the tax code, please feel free to give us a call to set up a meeting to discuss how we can best structure your estate plan and achieve broader tax objectives.