MassMutual

A STRATEGY SPOTLIGHT

Determining Fair Market Value of Businesses: Special Tax Rules for Family-Owned Businesses

Overview

When considering gift and estate tax rules that might affect family-owned businesses, it's important to have a qualified business valuation. It is a key element in the buy-sell agreement process, not only to ensure that the business interest is transferred at a fair price but also to help establish a value for estate tax purposes.

If a business valuation is not done, the Internal Revenue Service (IRS) may challenge the value that the owners have placed on the business. In turn, this could lead to litigation to determine what the true value is. If the court rules in favor of the IRS, there could be additional taxes, both at the business and the personal level.

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Buy-Sell Agreements Among Family Members are Subject to Three Requirements Set Forth in the Tax Law

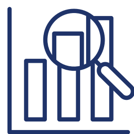
The three requirements are:

1 | The buy-sell agreement must be a bona fide business arrangement;

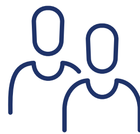
2 | It must not be a device to pass the business interest to members of the decedent's family for less than adequate consideration; and

3 | The terms must be comparable to similar arrangements made by unrelated parties in an arm's length transaction.

KEY POINTS



Importance of valuation



The standards for related parties

Possible consequences for getting it wrong

Another requirement is that the buy-sell price must be binding during lifetime on any attempted sale as well as at death. (Note: this can be either a mandatory purchase or an option to be exercised by the business or the other owners depending upon the buy-sell arrangement).

The rules under the Internal Revenue Code (IRC) are designed to make it difficult to pre-establish the estate tax value of family-owned businesses with a buy-sell agreement. It must be shown that it is comparable in price and terms to those that would be entered into by unrelated parties. This requires consideration of the expected term of the agreement, the current fair market value (FMV) of the business, and anticipated changes in value during the term of the agreement. Thus, it is no longer possible to freeze the value of a family-owned business to a fixed buy-sell price.

Treasury Regulations provide a safe harbor to "Smith-Jones" corporations (those that are not completely owned by family members). Agreements are deemed to meet the three requirements of the IRC if more than 50 percent in value of the business is owned by persons who are not members of the decedent's family and are subject to the same terms. However, these regulations also expand the definition of family to include lineal descendants of the parents of the decedent or spouse (siblings, in-laws) and anyone who is a natural object of the decedent's bounty.

Three Tax Traps in Family-Owned Businesses

There are three potential tax traps that must be considered when structuring buy-sell agreements for family-owned businesses.

- First, a buy-sell price between family members will be disregarded for estate tax purposes, and the business will be valued at FMV unless the agreement meets the comparability test;
- Second, a business interest that is subject to a buy-sell option price less than FMV will not qualify for the marital deduction because someone other than the spouse has a power of appointment. Thus, the business may be taxed at FMV in the stockowner's estate and the difference between the FMV and the actual buy-out price will not qualify for the marital deduction; and
- Third, if the optionees (e.g., children) fail to exercise their option to buy at less than FMV, they may be treated as having made a gift (e.g., to mother) of the excess value.

The Bottom Line

In light of these possible tax traps with a family business buy-sell plan, some alternatives should be considered:

1. Leave the buy-sell price open to whatever may be the FMV at death, and take out extra life insurance to try to cover the possible higher value;
2. Similarly, if the stockholder is married, leave the buy-sell option open until the second death, and fund the buy-out with second-to-die life insurance; or
3. If children are to be the ultimate owners, do not use a buy-sell agreement, but leave the business to them and have insurance (individual or second-to-die) owned by them, or a trust, to cover the estate taxes on the business.

MassMutual does not provide qualified business valuations. For a qualified or certified business valuation, consult a properly credentialed appraiser.

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