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Using the Estate Tax Exemption to Transfer Stock Tax Free

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A looming 50% decrease in the amount of assets an estate can transfer tax free has created urgency for wealthy families to see about transferring valuable assets — including private company stock — to heirs by the end of 2025, says Eric Clarke of Hanson Bridgett LLP.

The current estate tax exemption expansion, which is set to expire for estates and gifts dated after December 31, 2025, presents wealthy families a window of opportunity to transfer substantial assets to descendants tax free. In 2024, the exemption is $13,610,000 for individuals and $27,220,000 for a married couple. In 2025, that amount is projected to increase to approximately $14 million for individuals (approximately $28 million for married couples).

On January 1, 2026, unless Congress intervenes, the 2017 Tax Cuts and Jobs Act provision that raised the amount temporarily will sunset, leaving the exemption to revert to its pre-TCJA level, which, adjusted for inflation, will be about $7 million for individuals and $14 million for couples. This looming 50% decrease in the amount that can be transferred tax free has created urgency for wealthy families to determine the viability of transferring valuable assets — including private company stock — to children and grandchildren by the end of 2025.

Taking Advantage of the Estate Tax Exemption

The estate tax is a federal tax imposed on the transfer of property upon one's death. It applies to the fair market value of an individual's assets at the time of death. Generally speaking, the estate tax rate is 40% of the value of assets in excess of the exemption — it starts at 18% at the taxation threshold and rises in quick brackets to the maximum 40% at $1 million past the threshold. Estates valued at less than the exemption for the year of the grantor's death are not subject to the estate tax at all. Thus, most estates don't need to pay estate tax, and this is especially so while the expanded exemption amount is in effect.

For families with significant shares of stock in private companies, the increased estate tax exemption presents an opportunity to transfer an increased amount of wealth to their children or grandchildren without triggering estate tax liabilities, provided the total value of the transferred assets falls within the exemption limit. In addition to the benefit families can recognize by gifting stock to younger generations, the IRS recently clarified, in Treasury Decision 9884, that individuals taking advantage of the increased gift and estate tax exclusion amounts in effect from 2018 to 2025 will not be adversely impacted if their death occurs after 2025 when the exclusion amount is scheduled to revert to 2018 levels. In other words, if they gift the assets while the current rules are in place, but die after the sunsetting of those rules, the current rules will still apply. This guidance has provided additional comfort to individuals planning to take advantage of the opportunity to use the existing estate tax exemption.

Taking Advantage of Recognized Discounts

Another significant benefit available to individuals seeking to use the estate tax exemption to gift private company stock is the valuation discount methods applied to private companies. In order to properly gift stock in a private company by use of the estate tax exemption, the individual making the gift must first have the stock valued. The individual gifting the stock will be required to file a Form 709 Gift Tax return with the IRS verifying the value of the gifted stock.

When valuing a private company, most valuation experts apply significant discounts to the reported valuation where the transfer involves a minority (non-controlling interest) in the company's stock. These discounts are known as the lack of marketability and the lack of control discounts. They are applied because there is no public market for stock in a private company and because minority shareholders do not have the power to control the future strategic decisions of the company. Depending on the circumstances, the discount rate used by the valuation expert can be significant, extending a further additional benefit to the individual making the gift.

Example

Jim and Kate Smith are the founders of a food production business ("Foodco") that operates in six states. They own all 1,000 shares of the outstanding stock. A recent third-party appraisal of Foodco estimates its fair market value at $40 million. The Smiths intend to continue operating the business for another 10 years, but would like to transition some of the ownership to their two children while retaining majority owner status.

They can transfer to their two children equal amounts totaling up to 49% (or 490 shares) valued at $19.6 million entirely tax free in 2024 because Jim and Kate (as husband and wife) together have a $27,220,000 exemption to work with.

Using the recent $40 million fair market valuation of Foodco, the Smiths can request an updated valuation for the transfer of a non-controlling (or minority) interest in the business. A typical valuation result would apply somewhere in the range of a 20% discount for the transfer of a non-controlling interest such that, for purposes of filing a Form 709 Gift Tax return, the $19.6 million may be reduced by as much as $3,920,000 to $15,680,000.

All of that $15.68 million is tax free. But for such transaction occurring after Dec. 31, 2025, with the exemption reverted to $14 million for a married couple, about $1.68 million will be subject to tax. That'll mean about $617,000 to Uncle Sam.

Extending the Sunset?

It is difficult to assess what Congress will elect to do with the current estate tax exemption. The last time the exemption was scheduled to expire, on December 31, 2012, Congress passed legislation at the 11th hour to extend the exemption and to modestly increase it from $5,120,000 to $5,250,000 per individual. Since that time, the Tax Cuts and Jobs Act passed by Congress in 2017 has increased the exemption by more than $8 million per individual. Congress has given no indication as to how it will treat the current exemption. Critics of the exemption argue that it unduly benefits wealthy families and permits them to avoid paying tax on unrealized capital gains. The fate of the current exemption level will likely turn on the results of the November elections.

Estate-Specific Practical Planning Considerations

Practitioners should address the following matters with clients considering using the estate tax exemption to gift private company stock:

- Do the company's organization documents permit a transfer to your children or grandchildren or does it trigger a buy/sell provision (or require the company's consent)? If a prohibition exists, either an amendment to a governing document and/or third-party consent must be secured to permit the transfer.
- Is the gift consistent with your estate plan or will it require an amendment?
- Does the company have a shareholders' agreement that will prohibit the recipient of the shares from transferring the stock? If not, a Shareholders' Agreement prohibiting such a transfer should be put in place before making the gift.

Conclusion

The use of the estate tax exemption for passing stock in a family-owned company from parents to children is a powerful estate planning tool that can help families preserve and transfer wealth across generations. By relying upon the exemption through gifting strategies, families can minimize estate tax liabilities while ensuring the orderly transfer of assets to the next generation. However, it's crucial to approach these strategies with careful planning and consideration of the unique circumstances and objectives of each family.

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Author Information

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