

PO BOX 655

1 EAST STATE ST

SHARON, PA 16146

(724) 346-0150

The Business Value Manager

Protecting your Private Company Wealth from the Government

*Advice
for business
owners,
investors and
service providers
on how to build
value and wealth
through
investment in
closely held
companies.*

Executive Summary—Page 2

Introduction

Private company business owners who have spent years building wealth for their families must never lose sight of the need to protect that wealth from a government aggressively looking for opportunities to confiscate it. Too often, entrepreneurs find that a large portion of the assets they have accumulated may not be available to benefit their families after their death due to estate and inheritance taxes. Recent court decisions threaten the use of very popular estate planning techniques, particularly Family Limited Partnerships (FLPs) and Limited Liability Companies (LLCs), to shelter assets from estate taxes.

If much of your family wealth is concentrated in assets tied to a private company or associated real estate and you have not recently reviewed these matters with your estate-planning attorney, your family's financial health and well-being might be at risk. This edition of *The Business Value Manager* provides a review of these wealth preservation tools, and offers suggestions to avoid threats from recent court rulings.

How FLPs and LLCs Work in Estate Planning

FLPs, and to a lesser extent LLCs, are commonly used by business owners and wealthy individuals to manage and preserve family wealth and to transfer assets at discounted values to intended beneficiaries.

Operationally, individuals employ FLPs to contribute closely held business interests, real estate, or marketable securities to a partnership formed with their children or other beneficiaries and they receive ownership interest in the FLP in exchange for the assets contributed to it. Traditionally, the parents are the General Partner (GP), and over time, they give some or all of the Limited Partner (LP) interests to their children.

As the transfer process occurs, the parents maintain control over the FLP assets through their role as the GP, even if they transfer up to 99% of the assets to the LP interests.

In transferring LP inter-

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(Continued on page 2)

(Continued from page 1)

Through FLPs, most of the asset value is transferred with the parents retaining a small ownership stake. By designating themselves as general partners, the parents continue to make management and investment decisions for the FLP because they retain control. In this transfer process, the parents also avoid significant gift and estate taxes.

ests, rather than the underlying assets, the fair market value of the gifted interests are subject to a significant valuation discount due to the diminution in value that occurs through the LP ownership structure. These discounts frequently range from 30% to 50% of the value of the underlying assets that were contributed. It is through these valuation discounts that the parents are able to transfer assets from their estate to their beneficiaries at reduced values for gift tax purposes.

The basis for the discount rests in characteristics of the LP interests, which tend to lack control over the operating entity or the underlying partnership. Courts have consistently ruled that these discounts are appropriate because of the LP interests' inability to distribute the partnership capital or profits and because of the significant restrictions that limit each LP partner's ability to sell their LP ownership interest.

EXECUTIVE SUMMARY

- ◇ Recent tax court decisions may threaten your private company wealth.
- ◇ This wealth can be effectively sheltered from gift and estate taxes through family limited partnerships.
- ◇ Assets can be transferred to beneficiaries at discounted values that reduce taxes while the donor retains control over the transferred assets.
- ◇ New IRS strategies that oppose such wealth transfers have been upheld in several recent court rulings.
- ◇ Private company owners should have their partnership agreements reviewed by their estate tax advisor to protect their wealth and minimize their taxes.

Traditional IRS Attack

Traditionally, the IRS has opposed this estate planning technique by attacking the valuation discounts applied to the LP interests. The Service has generally been unsuccessful with these arguments, which claim the FLP has "no business purpose," or possesses other manipulative measures.

New IRS Attack

More recently, the Service has relied on IRS Section 2036 in estate tax cases to attack FLP and LLC strategies for value reduction. Their goal is to have the transferred assets included in the estate of the contributed taxpayer at their respective fair market values. For this reason, private company owners and other individuals engaged in family wealth management and preservation are urged to consult with their estate and gift planning advisors to ensure that their plans are appropriately updated in the light of these new changes.

Two key provisions in Section 2036 (a) aim to have the transferred assets included in the estate of the contributing taxpayer at full value. If the taxpayer retained certain control over those assets or received certain benefits from them, under Section 2036 (a) (1), the property could be included at full value in the estate if the decedent retained the right to, or the power of enjoyment from, the income from the assets. This is known as the "*retained economic provision*."

Under Section 2036 (a) (2), the full value of the property could be included in the estate if the decedent retained for life the ability to control alone or with others who may enjoy or possess the property or its income. This is known as the "*retained control provision*."

In essence, the IRS is taking the position that the decedent's estate should include at full value property that had been legally transferred, but over which the taxpayer had retained the benefits of control and use. The IRS would then claim that the taxpayer had engineered the transfer merely to avoid payment of estate taxes upon death. In the process, the valuation discounts that are eliminated include the minority interest discount (also known as lack of control discount) and discount for lack of marketability, which are the adjustments

(Continued on page 3)

VALUATION ADVISORY SERVICES

(Continued from page 2)

typically associated with FLPs.

Several recent court cases, including *Thompson*, *Strangi*, and *Kimbell*, reveal the new IRS strategy to attack FLPs primarily as an estate tax argument rather than as a gift tax argument. Given the results of these cases, and the new scrutiny imposed by the IRS, the lesson for family business owners and their advisers is clear: Your FLP and LLC agreements should be carefully reviewed and adjusted if necessary to comply with these new standards.

A review of several key factors or conditions in these cases clarifies the basis for the IRS court victories.

- Advanced age and poor health—The legal entity was formed when the taxpayer was elderly and in declining health, suggesting anticipation of death.
- Majority of wealth transferred—So much of the taxpayer's wealth was transferred to the new entity that the contributor lacked adequate income to support their personal needs.
- Concentrated transfers—Distributions from the FLP were disproportionately made to the taxpayer to support

their personal needs.

- Personal use assets transferred—Assets used and enjoyed exclusively by the taxpayer, including their personal residence, were transferred to the new entity.
- No legitimate business purpose—The assets were transferred simply to avoid payment of estate taxes by changing the form of ownership of the contributed assets.
- Funds management and record-keeping—Business and personal cash and other assets were co-mingled with incomplete or inadequate record-keeping.

CONCLUSION

Few events are more disturbing or threatening to private company owners than to have the wealth they have worked so hard to accumulate taken by the government due to inadequate or faulty tax planning. In light of recent court decisions, have your estate tax advisor review your partnership agreements and overall estate plan to insure that they are in compliance with the latest regulations and court rulings, and if you have valuation or wealth management related questions about your private company, please call us.

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Section 2036 Do's and Don'ts

The following is a list of planning suggestions to encourage compliance with the new Section 2036 provisions:

- **Create the partnership or LLC while you are in good health, and if elderly, establish your state of health with a medical report.**
- **Retain sufficient assets, including your personal residence, outside the partnership to provide for your personal needs.**
- **Reduce or even give up control over partnership assets by naming an independent third party or children as the general partner.**
- **Make partnership income distributions mandatory and on a pro-rata basis according to each partner's ownership stake.**
- **Carefully account for all partnership income, expenses and assets and pay no personal expenses from the partnership account.**
- **Promptly pay all rent or similar expenses on partnership assets owned by a related party at a rate that reflects fair market value.**

EVANS AND ASSOCIATES

VALUATION ADVISORY SERVICES

P.O. Box 655
One East State Street
Sharon, PA 16146

Phone: 724-346-0150

Fax: 724-342-4510

fevans@evansandassociates.net



Frank C. Evans
ASA, CBA, CPA/ABV
fevans@evansandassociates.net

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www.evansandassociates.net

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