



GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

Business Valuation: Estate/Gift Planning & Current Perspectives



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Business Valuation: Estate/Gift Planning & Current Perspectives

INTRODUCTION



Estate/Gift Planning & Current Perspectives

INTRODUCTION

- *Estate planning has taken center stage*
 - Presidential election
 - COVID is providing opportunities as many businesses have experienced a decrease in their value



Estate/Gift Planning & Current Perspectives

INTRODUCTION

- *Various entity structures used by taxpayers seeking asset protection and minimization of income and transfer taxes*

- *Tax Reform Act of 1986 – double layer of taxation*
 - Catalyst for popularity of “pass-through” entities
 - Elimination of General Utilities



Estate/Gift Planning & Current Perspectives

INTRODUCTION

- *Types of pass-through entities*
 - Proprietorships
 - Partnerships
 - S Corporations



Estate/Gift Planning & Current Perspectives

INTRODUCTION

- ***S Corporation Limitations***
 - More restrictive and less flexible
 - Shareholder type and number
 - Single class of equity ownership
 - Difficult loan basis rules



Estate/Gift Planning & Current Perspectives

INTRODUCTION

- ***Partnerships***
 - Offer greatest flexibility in planning for both business and transfer taxes
 - Opportunity to centralize family assets in one vehicle for control and management
 - Allows for discounted asset value transfers



Estate/Gift Planning & Current Perspectives

TOPICS OF DISCUSSION

- *Estate and Gift Tax and Exemptions*
- *Relevant Guidance*
- *Revenue Ruling 59-60*
- *Valuation Fundamentals*
- *Estate Planning Options*
- *Mechanics and Benefits of Family Limited Partnerships*



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ESTATE AND GIFT TAX AND EXEMPTIONS





Estate and Gift Tax Exemptions

OVERVIEW

- *We are currently have an environment that is ideal to gift assets with depressed values*
 - Maximize the use of an individual's gift tax annual exclusion and lifetime tax credit
- *In planning for potential estate tax changes it's important to understand both where we are and where we have been*



Estate and Gift Tax Exemptions

PLANNING FOR POTENTIAL ESTATE TAX CHANGES

- *Where we are:*
 - The Tax Cuts and Jobs Act (TCJA) substantially increased the unified federal gift and estate tax exemption
 - Individuals can gift up to \$15,000 per person per year without using lifetime gift tax credit



Estate and Gift Tax Exemptions

PLANNING FOR POTENTIAL ESTATE TAX CHANGES

- ***Where we are:***
 - For 2020 the unified federal gift and estate tax exemption is \$11.58 million with a flat tax of 40% for an estate value in excess of the exemption
 - Reverts back to \$5 million (adjusted for inflation) on January 1, 2026
 - Federal gift and estate tax exemption portability for married couples



Estate and Gift Tax Exemptions

PLANNING FOR POTENTIAL ESTATE TAX CHANGES

- ***Where we were:***
 - In 2000 the exemption was \$675,000, and the maximum tax rate was 55%
 - In 2005 the exemption was \$1.5 million, and the maximum tax rate was 48%
 - In 2009 the exemption was \$3.5 million, and the maximum tax rate was 45%



Estate and Gift Tax Exemptions

PLANNING FOR POTENTIAL ESTATE TAX CHANGES

- *Where we were:*
 - In 2010 estate executors could opt for a zero federal estate tax bill by surrendering the tax basis step-up
 - In 2015 the exemption was \$5.43 million with a flat tax at 40% for estates valued in excess of the exemption



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RELEVANT GUIDANCE





Relevant Guidance

INTERNAL REVENUE CODE – CHAPTER 14

- *Enacted in 1990 to circumvent and prevent “estate freeze” techniques*
 - Assumption that senior generation who transferred property to junior generation will not exercise retained rights if inaction is advantageous to junior generation
 - IRC Section 2701-2704: “Special Valuation Rules”



Relevant Guidance

IRC CHAPTER 14 – SPECIAL VALUATION RULES

- *Section 2701 – applies to transfer of interests in a corporation or partnership*
- *Section 2702 – applies to transfer of interests in a trust*
- *Section 2703 – applies to an option, agreement or other right to acquire or use the property at a price that is less than fair market value*
- *Section 2704 – applies to treatment of certain lapsing rights and restrictions*



Relevant Guidance

IRC CHAPTER 11 – ESTATE TAX

- **Section 2036** – *transfers with retained life estate*
 - Has become a formidable weapon for IRS in challenging FLP or LLC interests
- **Section 2038** – *revocable transfers*



Relevant Guidance

REVENUE RULINGS

- **Rev. Rul. 68-609** – *replaced ARM 34*
 - Sets rules for acceptable calculation methods and capitalization rates
- **Rev. Rul. 93-12** – *milestone ruling for family-owned businesses*
 - Paves the way for use of FLPs and other pass-through entities for estate planning purposes



Relevant Guidance

PENALTIES

- **IRC Section 6695A – Appraiser Penalty**
 - Added in Pension Protection Act of 2006
 - “Substantial valuation misstatement”
 - “Gross valuation misstatement”
- **IRC Section 6701 – abusive valuation practices**



Relevant Guidance

OTHER GUIDANCE – PPA

- ***Pension Protection Act of 2006***
 - “Qualified appraisal”
 - “Qualified appraiser”
 - New penalties create uneven playing field



Relevant Guidance

CONCLUSION

- *Care must be taken in developing estate planning strategies which can mitigate risks*
- *Understanding of IRC code and recent judicial decisions necessary to minimize IRS scrutiny and maximize benefits*



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REVENUE RULING 59-60





Revenue Ruling 59-60

DETERMINING FAIR MARKET VALUE FOR ESTATE AND GIFT TAX PURPOSES

▪ ***Key Criteria***

- Will depend upon the circumstances in each case
- Appraiser should use common sense, informed judgment and reasonableness
- Includes list of fundamental factors to be considered in the valuation process



Revenue Ruling 59-60

DETERMINING FAIR MARKET VALUE FOR ESTATE AND GIFT TAX PURPOSES

▪ ***Fundamental Factors to Be Considered***

- Nature of the business and history of the enterprise from its inception
- Economic outlook in general and condition and outlook of the specific industry in particular
- Book value of the stock and financial condition of the business
- Earnings capacity of the company



Revenue Ruling 59-60

DETERMINING FAIR MARKET VALUE FOR ESTATE AND GIFT TAX PURPOSES

▪ ***Fundamental Factors to Be Considered***

- Dividend-paying capacity of the company
- Whether or not the enterprise has goodwill or other intangible value
- Sales of stock and size of block of stock to be valued
- Market price of stock of corporations engaged in same or similar line of business, having stocks actively traded in a free, open market, exchange or over-the-counter



Revenue Ruling 59-60

DETERMINING FAIR MARKET VALUE FOR ESTATE AND GIFT TAX PURPOSES

▪ ***Prioritizing and Weighting the Factors***

- Earnings carry most weight for operating companies
- Asset values carry most weight for holding companies
- Necessary to use appropriate capitalization rates
- Avoid “double-dipping” in weighting



Revenue Ruling 59-60

RESTRICTIVE AGREEMENTS

- *Price of stock may be fixed by restrictive agreement*
 - Fixed price must be applicable during the life of the stockholder, and must be a bona fide business arrangement (does not apply for gift tax purposes)



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VALUATION FUNDAMENTALS





Valuation Fundamentals

STANDARDS OF VALUE

- ***Definition of “fair market value”***
 - The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is under no compulsion to sell, both parties having reasonable knowledge of relevant facts.



Valuation Fundamentals

PREMISE OF VALUE

- ***Assumption regarding the most likely transactional circumstances applicable to the subject valuation***
 - “Going concern”
 - “Liquidation” – orderly or forced



Valuation Fundamentals

DATE OF VALUATION

- *Date or dates on which the subject entity will be valued*
 - Critically important because events and circumstances can arise that can cause value to vary materially from one date to another
 - Influences the information available for the valuation
 - Perspective from which all analysis is performed



Valuation Fundamentals

DATE OF VALUATION

- *A valuation is prepared “as of” the valuation date, and subsequent events and data are typically not considered*
 - All information must be known or knowable to a potential purchaser of the subject interest as of the date of valuation



Valuation Fundamentals

ACCEPTED APPROACHES AND METHODOLOGIES

- ***Common approaches***
 - Income approach
 - Market approach
 - Cost/asset approach
- ***Many factors impact selection of approach used***
- ***Quality of information available and prospects for liquidation or continued operation***



Valuation Fundamentals

VALUATION DISCOUNTS

- ***Two primary areas of risk in partnerships***
 - Control (or lack thereof)
 - Marketability (or lack thereof)
- ***Discounts for lack of control and lack of marketability are the primary mechanisms used to modify value for partnerships lacking in these attributes***
- ***IRS has history of challenging these discounts***



Valuation Fundamentals

IRS GUIDANCE TO APPLYING DISCOUNTS

- ***Revenue Ruling 93-12 (1993)***
 - Allows that lack of control will not be disallowed simply by virtue of family ownership
 - Drove popularity of use of family limited partnerships
- ***IRS tried to mitigate some of the tax advantages by issuing a TAM introducing a “swing vote” premium***



Valuation Fundamentals

IRS ATTENTION

- ***Discounts are one of the Internal Revenue Service’s primary areas of concern and are regularly examined***



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ESTATE PLANNING OPTIONS



Estate Planning Options

GENERAL CONSIDERATIONS

- *Successful estate planning often depends on timing*
- *Current financial market, COVID, reduced interest rates combined with an era of historically high estate tax exemptions to create an opportune time to review and revise estate plans*
- *Numerous estate planning strategies exist*



Estate Planning Options

STRATEGIES TO CONSIDER

- ***Gifts***
 - Equity interests in closely held companies
 - Leverage gift tax annual exclusion and lifetime gift tax credit
- ***Intra-family loans***
 - Take advantage of low interest rate environment
 - Freeze the value of an asset in an estate without using lifetime tax credit



Estate Planning Options

STRATEGIES TO CONSIDER

- ***Sell or loan assets to a trust***
 - Move asset appreciation out of the estate
 - Provides asset protection
- ***Grantor Retained Annuity Trusts (GRAT)***
 - Effective in low interest rate environment when asset values are low
 - Transfer assets and retain an annuity interest for a defined term



Estate Planning Options

STRATEGIES TO CONSIDER

- ***Charitable Planning***
 - Create a charitable lead annuity trust (CLAT)
 - Leave the remainder interest to family members free of gift tax



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FAMILY LIMITED PARTNERSHIPS (FLPs)





Family Limited Partnerships (FLPs)

BENEFITS OF FLPS

- *Ability to leverage annual gift tax exclusion and lifetime giving exclusion by applying discounts for lack of control and lack of marketability*
- *Retention of control over transferred assets*
 - Senior generation transferors are general partners who control the decision-making



Family Limited Partnerships (FLPs)

EXCLUSION LEVERAGE TECHNIQUES

- *Two steps:*
 - Discounts at initial transfer
 - Post-transfer appreciation



Family Limited Partnerships (FLPs)

ADVANTAGES OF FLPS

- *Ease of amendment*
- *Protection from creditors*
- *Annual gift giving*
- *Simplicity of ownership*



Family Limited Partnerships (FLPs)

DISADVANTAGES OF FLPS

- *Cost (professional fees for attorneys, business valuers)*
- *Loss of IRC Section 1014 basis step-up (possible higher income tax costs)*
- *Investment company characterization*
- *Integrity challenges*



Family Limited Partnerships (FLPs)

MECHANICS OF AN FLP

- ***Created by transferring assets to a newly-formed limited partnership***
 - Such contributions to capital, if done properly, can be accomplished without the imposition of tax on either the transferor or the transferee partnership
 - Generally, the most desirable properties to contribute to the limited partnership are those that will likely see significant appreciation over the planning period



Family Limited Partnerships (FLPs)

MECHANICS OF AN FLP

- ***Key consideration in selection of assets will be the value of the assets expected to be transferred***
 - Property commonly transferred includes real property, appreciating financial securities and oil and natural gas mineral rights
 - Appraisals and valuations must be obtained to determine the value of the assets to be transferred



Family Limited Partnerships (FLPs)

MECHANICS OF AN FLP

- ***Next step is creating a partnership agreement and registering the limited partnership***
 - Requires careful focus and attention of legal advisors
 - Valuation professionals may be consulted to review the partnership agreement to advise on how the provisions may affect the final valuation



Family Limited Partnerships (FLPs)

MECHANICS OF AN FLP

- ***A limited liability organization is often created to hold the general partner ownership interest***
 - Done to address concerns over the exposure of remaining senior generation family assets to general liabilities of the partnership
 - Limited liability companies serving as general partners in a family limited partnership are usually taxed as partnerships



Family Limited Partnerships (FLPs)

MECHANICS AND BENEFITS OF PLANNING WITH FLPS

- ***Funding the family limited partnership***

- Initial contribution accomplished by providing capital to the general partner entity in exchange for its capital ownership interests, and through the contribution of assets to the partnership for all of the limited partner ownership interests
- The general partner entity then contributes capital to the limited partnership in exchange for its general partner ownership interests



Family Limited Partnerships (FLPs)

MECHANICS AND BENEFITS OF PLANNING WITH FLPS

- ***Valuing the limited partner ownership interests***

- Includes discounts for lack of control, lack of marketability
- Valuation is performed in addition to other appraisals and valuations performed earlier in the process
- Conclusions of value set forth in this valuation will set the course for how many limited partner ownership interests will be transferred in accordance with the planning strategy developed by legal counsel



***Business Valuation: Estate/Gift Planning
& Current Perspectives***

CONCLUSION & PRACTICAL CONSIDERATIONS



Estate/Gift Planning & Current Perspectives

CONCLUSION AND PRACTICAL CONSIDERATIONS

- *The current environment is providing opportunities to transfer wealth*
- *Properly prepared valuations will protect against potential IRS challenge*
- *Planning options exist beyond what we discussed today*



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THANK YOU FOR ATTENDING!

