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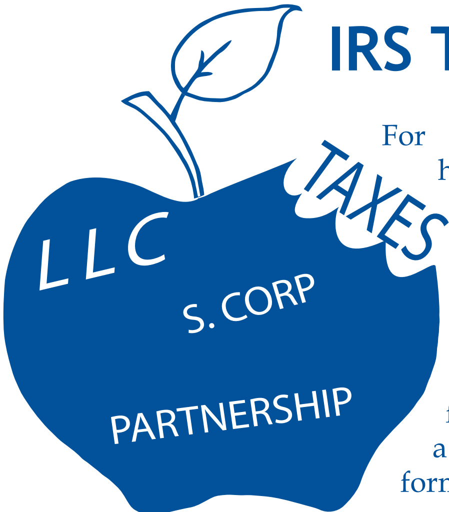
IRS Targets Family-Owned Businesses



For decades, the IRS has found new ways to challenge the valuation of family-owned businesses. There are many reasons why a family may own a business in the form of a partnership, corporation or limited liability company (LLC). When one of the owners dies or transfers his or her interest (by gift, sale or otherwise), the value of the owner's interest is often discounted due to the fact that the interest may be a minority interest in the business and due to the lack of marketability of that interest.

For example, a partnership may own a farm with a value of $1,000,000. If one of the partners owns a 25% interest in the partnership, that interest does not necessarily have a value of $250,000. Instead, the interest may be discounted. The amount of the discount varies, but a discount of 20% to 40% would not be unusual. Accordingly, if that individual gifts his or her 25% interest in the business, the value of the gift for gift tax purposes could be $200,000 or less (depending upon the discount), and the value would be discounted similarly for estate tax purposes if the individual dies owning the interest.

Valuation discounts have resulted in the IRS collecting less gift and estate tax than it would if valuation discounts did not apply. Based on the example above, the IRS could collect more tax if a 25% interest in the business is worth $250,000 (one–quarter of the undiscounted value of the company).

The latest approach by the IRS to quash valuation discounts was issued in August 2016 in the form of Proposed Treasury Regulations. The Regulations are not binding until the IRS makes them final, so valuation discounts remain in place for now. There is no set date when they will become final, but a public hearing on the Regulations is scheduled for December 1, 2016, so they will not become final until sometime after that date.

One of the primary objectives of the Regulations is to require that valuations of family-owned businesses ignore certain attributes that typically support valuation discounts. For example, a partner holding a 25% interest in a partnership may not have the right to force the partnership to redeem (purchase) the partner's interest. The fact that a partner cannot easily get out of the partnership can help support discounting the value of the partnership interest. However, under the Regulations, the value of the 25% partnership interest is determined by ignoring the partner's inability to force a redemption. The goal of the Regulations is to value the 25% partnership interest at a higher value under the new rules than under current rules.

There are many unanswered questions about the Regulations and how they will actually operate. Also, it is quite possible that revisions will be made to the Regulations before they are made final. The fact that there are many unknowns surrounding the Regulations presents a challenge for planning with family-owned business.

The Regulations have the potential to negatively impact individuals with taxable estates for estate tax purposes. For federal estate tax purposes, a taxable estate for a single individual is currently an estate over $5,450,000 ($10,900,000 for a married couple). Anyone with assets in this range that include family-owned business interests, should be particularly mindful of these Regulations.

It may be appropriate to make gifts of family-owned business interests before the Regulations become final to take advantage of the availability of valuation discounts while they are still permitted. However, that decision requires a case-by-case analysis. We can assist our clients in analyzing options for family-owned business interests, including whether gifting business interests in the near future may be advisable.

Planning for Gifts to Minors: Avoiding the White Elephant

Parents and grandparents often wish to leave assets "to" their minor children and grandchildren for reasons ranging from the heartfelt to the practical. However, under Colorado law, minors cannot manage or deal with property devised or gifted to them outright. This means that if you simply list a minor as a beneficiary on, for example, a beneficiary designation form, court proceedings may become necessary to appoint a conservator to manage the assets on the minor's behalf until he or she reaches the age of majority.

The appointment of a conservator requires several steps, and the process can be arduous. Even if the minor's parent serves as conservator, the court requires that the nominated conservator submit a credit report and background check. Once the court approves the conservator, he or she will need to work with the court to determine a budget for use of the conservatorship assets. Non-budgeted expenses may require a court hearing to determine whether they are permissible. The conservator must also make periodic reports and accountings to the court, itemizing all receipts and disbursements from the conservatorship accounts. As you can imagine, the process of administering a conservatorship can be quite involved.

For the year 2017, the estate and gift tax exclusion amount will be $5,490,000

To prevent your generosity from resulting in a headache and avoid your gift being gobbled up by legal fees, there are several options to effectuate a smooth transfer of assets to (or for the benefit of) minor beneficiaries.

Colorado Uniform Transfers to Minors Act (CUTMA)

Under the CUTMA, a gift can be made to an adult as "custodian" to hold property for a minor beneficiary. During the custodianship, the custodian must protect, invest, and distribute the property for the beneficiary's benefit. There are some potential downsides to CUTMA gifts, however. When the beneficiary reaches age 21, the custodian must turn over the property to the beneficiary. This transfer is not optional, even if the beneficiary isn't yet responsible enough to independently manage the property. Because the custodial property legally belongs to the beneficiary after the transfer, the property may be reached by the beneficiary's creditors. Further, CUTMA transfers are irrevocable (even if their value grows substantially).

529 Plans

If a donor's generosity is aimed solely at the minor's education, 529 Plans can be a useful vehicle. The donor owns the 529 account and retains control over investment decisions and distributions. The owner can also change the beneficiary of the account at any time, without penalty, so long as the new beneficiary is a qualifying family member. The account's earnings grow free from federal income tax, there are no tax consequences when the assets are used to pay qualified higher education expenses, and many states (Colorado included) offer tax deductions for 529 contributions. However, 529 Plans are fairly restrictive. If the assets are used for a non-qualified expense, the interest earned on the assets distributed is generally subject to a 10% penalty, and any contribution deductions claimed may be subject to recapture.

Gifts in Trust

Gifts to a trust for the benefit of minor(s) can be a useful way to ensure that property is managed and distributed to the beneficiary according to the donor's wishes. In contrast with the options above, when creating a trust, the donor has some latitude to determine the trust's terms, duration, and permissible distributions. The trust assets are managed by a trustee, and the donor may restrict or permit the trustee's use of its discretion in making distributions. However, trusts can have significant income, gift, and even generation-skipping transfer tax consequences, and the administration costs may prove impractical if the trust holds only minimal assets. It is important to work with an experienced attorney when creating trusts to address and minimize these tax and administration issues.

Conclusion

Many alternatives exist to facilitate gifts "to" minors. Each option discussed above allows a donor to make such a gift while designating an adult with the power to control the gifted assets for the minor's benefit – all without the hassle of involving the court.

Serving as Personal Representative: Not for the Faint of Heart

When preparing an estate plan, one of the most important choices you can make is who will be the executor (called a "personal representative" in Colorado) of your estate, or the trustee of your revocable trust after you die. This choice is often not given much thought, but should be. A person nominated as a personal representative should also be certain that he or she is up to the job before automatically accepting it.

If you are nominated as personal representative or trustee, but are not sure you want to accept the appointment, check the document to see if there is a successor if you renounce. Even if there is not, the Colorado Probate Code provides a priority list delineating who the court may appoint as personal representative to administer an estate. In some cases, those with priority for appointment may appoint someone else to serve in their place.

When deciding who to name as personal representative or trustee, or conversely, whether to accept appointment, there are a number of factors that should be considered.

Time Commitment

Not only is there a lot to do, especially at the beginning of the estate administration, but some tasks can take a very long time. An inventory will need to be prepared, a United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) may be required, and it may be necessary to sell assets. In all of those cases, it is important to obtain valuations. If property is held in an LLC, partnership or corporation, it may be necessary to not only value the assets owned by the entity, but also the decedent's interest in the entity.

Rarely is an estate closed in less than a year, and in many cases, several years can pass before all issues are resolved.

Unforseen Problems

Grandma may have had problems you never dreamed of. She could have outstanding and possibly overdue debts. Those could include contested medical bills, unpaid mortgages or claims being asserted by tax authorities. These may result in litigation and the engagement of additional attorneys besides those advising you on the basic tax and estate administration matters. As a personal representative, you will not be personally liable for Grandma's debts, assuming you handle them correctly, but it will be your job to settle the claims in the estate.

Property in More Than One State

Uncle Fred's vacation cabin in Maine will require the help of competent counsel in Maine, including (in most cases) an additional probate proceeding. There also may be estate tax and income tax reporting requirements in that state.

Contentious Beneficiaries

When Mom and Dad pass, things can get ugly. Sibling rivalry is seemingly forever and can lead to sleepless nights and large lawyers' bills if even one disgruntled beneficiary decides that he or she is not being treated fairly. Even if the entire estate is being divided evenly, a beneficiary can sue the personal representative for breach of fiduciary duties.

Nobody Wants Mom's Stuff

Selling assets, especially tangible personal property, can be especially frustrating. The market for used household items is not robust, and even thrift stores have become finicky about donations. Prepare to spend many hours sifting and sorting before finally paying someone to haul things away. Even though the real estate market is currently strong in Colorado, preparing a property for sale, hiring a realtor and negotiating a series of contracts can be a challenge.

Conclusion

While agreeing to act as personal representative for a parent or other close relative may seem like the right thing to do, it may be advantageous to all concerned to convince Mom and Dad to name a competent corporate fiduciary instead. It's their job; they are good at it; and the fees are, in almost every case, justifiable. If you do agree to take the job, we can help with almost all of the above referenced tasks which will lighten your load significantly and help you administer the estate properly, thereby reducing your exposure to liability to the beneficiaries of the estate, creditors and the IRS.

Be aware that many of the same considerations apply to plans which utilize wills or revocable trusts. Despite rumors to the contrary, avoiding probate does not avoid all of the issues discussed above.

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ROLL CALL

Jennifer Spitz wrote an article on the topic of planning for out-of-state property, such as vacation homes, oil and gas interests, family farms and rental properties. The article was published in the August 2016 edition of The Colorado Lawyer. She also gave a presentation on this same topic for the Boulder County Estate Planning Council in July 2016. Jennifer has again been included in the The Best Lawyers in America® in the practice areas of Trusts and Estates and Tax Law.

Kate Keiser joined the Board of Directors of TLC Learning Center (formerly Tiny Tim) in Longmont, Colorado in May 2016. TLC provides an inclusive approach to high-quality early childhood education, where typical and special needs children learn together, side-by-side. Kate is expecting her second child in early November.

The Alps beckoned and **Tom Stover** answered the call with a two week long, 110 mile trek around Mt. Blanc in mid-August. He is shown here crossing the border from Italy to Switzerland on one of many perfect blue sky days. Beginning and ending in Chamonix, the adventure took him through some of the most beautiful parts of France, Switzerland and Italy. The food wasn't bad either.

Stover & Spitz LLC is a Tier 1 Trust and Estates law firm, as recognized by U.S. News Best Law Firms.