DEEPER DISCOUNTS = REDUCED TAXES

by
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Last month we discussed the issue of double discounts and concluded that taking two discounts on the same asset would not be acceptable - to say the least - to the IRS. We further concluded, however, that a properly structured Fortress plan could provide two distinct discounts, albeit on two separate assets.

This month, I would like to carry the concept of discounts a step further and discuss how careful planning can deepen the discount for lack of marketability and minority interest.

ISSUE: Mr. and Mrs. B own a successful family business and are planning on contributing the stock of the business to their newly created family limited partnership.

We will assume that there is a business reason for the partnership and that Mr. and Mrs. B hope to pass the business on to their children, who are employed in the business, through gifting and the ultimate disposition of their estate. Mr. and Mrs. B are, therefore, very interested in any legitimate concept that will allow them to reduce the taxable value of the stock of the company. A lower taxable value allows for an increased gifting program during life and reduced estate taxes following the ultimate disposition of the estate. We will further assume that the Bs are adamant that only active employees will be allowed to own stock in the company.

The Bs contact their attorney, CPA and valuation consultant to request advice on how the taxable value of the company might be reduced to its lowest legitimate point.

BACKGROUND: The successful valuation of limited partnerships requires a very clear statement as to the assets being valued. An inexperienced valuator can easily fall into the quagmire of valuing the underlying assets (assets held by the partnership). This is a critical error that will generally lead to the overvaluation of the partnership. The proper asset to value is the partnership interest that is being transferred. Case law and valuation theory have long sense determined that owners of a security - stock or partnership interest - have no right to the underlying assets of the organization, but rather to a proportional share of the earnings produced by the on-going business.

Even though this concept is critical to the valuation process, it is also true that the quality of the underlying assets plays a role in the overall determination of value. Marketable majority interest in an asset held by a partnership is more valuable than an unmarketable minority interest. The quality of the underlying assets is, therefore, an important and appropriate issue to study, although it's the partnership interest that is actually being valued.

CONCEPT: With this point in mind together with the goals of the B family, a concept was presented which would decrease the marketability of the stock in their company prior to its contribution to the partnership. It was suggested that the Articles of Incorporation be amended to require, say, four layers of first refusal rights on the transfer of stock, plus a requirement that only active employees can own stock in the company.

First refusal rights on the transfer of stock would be structured such that the company would have the first opportunity to purchase a departing shareholder's stock, followed by senior officers of the corporation, management and finally the general employee population. Each of these first refusal rights

would have 30 days to act. In addition, the company's attorney would change the Bylaws of the corporation to require that only employees can own stock in the corporation.

CONCLUSION: Several business goals are accomplished through the use of this concept. First of all, the Bs are insuring that the people most responsible for its success will control the company over the years. Continuity of management will be preserved and management will be rewarded with ownership opportunity. Secondly, the changes to the Bylaws have insured that only employees can own stock; thus protecting against unwanted minority shareholders brought about by divorce or estate distributions.

In addition to the valid business reasons for the suggested design, significant barriers to marketability of the stock have been created. This will require the valuator to establish a deeper discount for lack of marketability, which will, in turn, reduce the fair market value of the company as a whole. The result will be that the value of the stock being contributed to the partnership will be significantly reduced as it enters the partnership. The valuation consultant performing the valuation on the partnership will then determine the value of the partnership interests with due consideration given to the quality of the underlying assets.

This technique can significantly reduce the taxable value of a family limited partnership, but great care must be taken and the CPA, corporate attorney and valuation consultant must be working in consort. It is necessary that a valid business reason exist for the design of the Articles and Bylaws. These actions cannot be taken solely to reduce taxes. Also, the valuator must be very careful to construct his report such that it does not appear that double discounts are being taken. Remember, we do not advocate double discounts, but rather properly constructed discounts on differing assets. Timing is likewise critical. The changes in the incorporation documents must be done prior to the contribution of stock to the partnership
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Be careful! Seek gook advice!