# CH. 18 Family Business Restructurings

Possible options for arrangements to

1) Sell an interest in a closely held enterprise to non-family members at retirement or death, i.e., no continuing family involvement. Chapter 19.
2) Shift ownership in closely-held family enterprise from older generation members to younger family members.

# Estate Planning Freeze in the Family Context

**Tax planning objectives:**

1) **freeze the enterprise value held by the older family members (with only limited gift tax effect), and**
2) **shift the future appreciation potential to the younger generation family members (i.e., children and grandchildren).**

**Note the applicability of valuation rules in the gift context – Code §§2701-2704.**

# Possible Family Enterprise Structures

1) Corporation, including an S (flow-through) corporation
2) Partnership, including a family limited partnership (or “FLP”), or a limited liability company (LLC) treated as a partnership
3) Joint tenancy ownership
4) Investment trust

# Family Relationship Considerations p.2

1) Financial security preserved/enhanced.
2) Preserving the family heritage.
3) Emotions concerning the family business.
4) Linking family members in the future.

**Note: Many family businesses fail in the second/third generation.**

# Corporate Restructuring – Income Tax Elements p.3

**Corporate tax elements:**

1) Corporate reorganization status of a restructuring?
2) Current dividend distribution upon a corporate ownership reshuffling?
3) Deferred dividend treatment for shareholders upgrading their positions? E.g., Code §306 stock, with possible elimination of §306 taint at death (§1014).

# Corporate Recapitalization p.3

Shifting of the ownership interests into a multiple tier structure:

1) Preferred (fixed value) stock for the older generation members, and
2) Common stock (appreciation potential) for the younger generation members.

# Corporate Reorganization Status

A corporate "recapitalization" is a tax-free reorganization. §368(a)(1)(E).

Family members can "recapitalize" the corporation with older generation members receiving senior equity interests (and younger members retaining or receiving junior stock, e.g., common stock).

# Current Dividend Distribution Risk p.4

**Code §305 provides for no ordinary dividend effect for a distribution of stock on stock, <u>except</u>:**

**§305(b)(1) – payable in stock or cash, at election of shareholder.**

**§305(b)(2) – distribution produces an increase in the proportionate interest of some shareholders**

**§305(b)(3) – transaction results in common stock to some and preferred stock to others**

# Estate Planning Recapitalization p.6

Special exception from this dividend treatment for an "isolated transaction," i.e., an "estate planning recapitalization."

See Reg. §1.305-3(e), Example 12, for the "isolated transaction" exception.

# Preferred Stock Bailout Treatment p.6

Code §306 provides for ordinary income treatment of the proceeds received upon the <u>disposition</u> of §306 stock.

No recognition when distribution of this stock occurs, but at the later disposition event (& ordinary income treatment).

Definition of §306 stock: other than common stock

# Gift Tax Risks in Recapitalizations

**Rev. Rul. 86-39, p.9: A recapitalization can result in the shifting of values between shareholders (& gift for gift tax purposes). Here, a transfer from one trust to another & outside of purview of eventual estate tax.**

**See Code §2701(e)(5) (p. 11) providing that a recapitalization can be treated as producing a transfer of an interest for gift tax purposes.**

# Other Shareholder Benefit Transfers p.13

Possible gift transfer treatment for:

1) Excessive salary payment to juniors.
2) Rent-free use of property to juniors.
3) Low interest loans to a relative.
4) Waiver of right to dividends. P.13 & Rev. Proc. 67-14.
5) Failure to convert preferred stock. P.14

# Family Limited Partnership (FLP) p.15

What is a "limited partnership"?

What is a "family partnership" (FP)?

See Code §704(e). What is a "family <u>limited</u> partnership" (FLP)?

In a family partnership capital must be a "material income producing factor."

Further, to enable income deflection the donor partner must respect the rights of the donee partners (minors?) after gift of FLP interests.

Flow-through treatment to the partners occurs for federal income tax purposes.

# PLR 9808010
# FLP Is Organized P.16

**Revocable trust for the parents as the GP (3%).**

**Children as the 1% limited partners in FLP.**

**1) LP interest transfers to 3 children (96% of FLP interests) were gifts. Partnership receives real estate (subject to guaranteed payment).**

**2) Value of gifts determined under the Code §2701 subtraction method. What is the "subtraction method"? *Next slide*.**

**3) §704(e)(2) allocation of income by FLP. P.20**

**4) §2703 buy-sell impact not determined here.**

# Code §2701 Rules
# P. 18-19

- §2701(a)(3) specifies that the value of a retained right shall be zero (i.e., all is a gift transfer), unless it is a retained right to receive a "qualified payment."
- §2701(c)(3) describes a "qualified payment" as an amount payable on a periodic basis at a fixed rate.
- §2701(a)(4) mandates a minimum 10% interest for the junior equity interest.

# Recent Gift Tax Cases p.22

Example: Holman case (8th Cir., 2010), re Dell stock transfer into FLP.

Issue: Gift of an FLP interest or a gift of the asset transferred to FLP? Held: FLP interest.

Noting also Pierre case, p. 22 in Tax Court (earlier in materials)., re (1) transfer of assets or (2) transfer of LP interest; including applicability of "step transaction" doctrine. Subsequent application of step-transaction rules.

# Gross Estate Inclusion Risks p.22

- Estate of Strangi case, re §2036, p.22
- Corporate GP of an FLP, using the "Fortress" FLP documents.
- Decedent had assigned 98% of his own (mostly liquid) wealth to FLP (done by agent through a durable P/A). FLP assets then used to fund donor's living expenses.
- Matter was remanded by 5th Cir. to U.S. Tax Court to consider the §2036 applicability.
- On remand (after Strangi II): Inclusion in the gross estate under both §2036(a)(1) & (2).

# FLP Litigation Risks and Strategies p.40

See IRS Settlement Guidelines, p.40.

1) Proper discounts for transfers of FLP interests? What percentage?
2) Code §2036/2038 inclusion?
3) Indirect gift of the underlying assets? Substance v. form.
4) Penalty exposure? §6662(g) – 20% for substantial valuation understatement.

# Appropriate Discounts? P.42

Code §2031 inclusion.

Discount for minority interests.

Discount for illiquidity (i.e., lack of marketable interest).

What discount for cash (& equivalents)?

# How Limit Potential §2036 Exposure? P.45

Do not transfer all client's assets into the FLP.

Do not pay personal expenses from the FLP.

Keep the capital accounts of the various partners balanced.

Continually keep good records & annual maintenance for the FLP. Run the FLP like a business.

# FLPs & Tax Policy p.56

Apply future limits to FLPs?

Limit where an infusion of liquid properties into FLPs occurs?

Does it constitute professional malpractice if <u>not</u> suggesting an FLP?  P.56.

Even if only for exclusively liquid assets?