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Business Solutions

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Business Valuation & Litigation Support Trends

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Add a Valuation to Your Estate Planning Toolbox

Business owners and attorneys usually consider a professional valuation a key component in a business transaction. But they may not realize that valuations are also essential tools in estate planning. Why? If you are involved in estate planning, either for yourself or for your clients, your goal is probably to pass as much to the heirs as possible while minimizing the estate tax burden.

A valuation can help reduce the chances that you or your client will face unexpected tax results or IRS penalties. The IRS may penalize businesses for several reasons, including undervaluation, lack of documentation or failure to pursue all relevant approaches to value—cost, income and market.

Cover All the Bases

What valuation formula is best for estate planning purposes? Although many business owners use formulas

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The Tax and Discount Advantages of Family Limited Partnerships

In the wake of Internal Revenue Service (IRS) policy changes over the past few years, tax planners have taken a renewed interest in family limited partnerships (FLPs). These entities may provide handy vehicles for gifting noncontrolling interests in the partnership at discounted values. However, while the IRS has to some extent relaxed its former restrictions on family attribution, it remains vigilant in attacking what it considers to be sham FLPs—those set up merely to avoid taxes through discounts. An important caveat is that an FLP must exist for legitimate business reasons before any significant tax benefits can be realized.

FLP Benefits

As long as it is considered legitimate, an FLP:

- Allows the appreciation of assets to occur outside the estates of older family members. (The transfer of wealth is subject to complex estate freeze rules, however, so obtain competent advice.)
- Redistributes property income from older-generation taxpayers in higher tax brackets to children and grandchildren in lower brackets.

- Uses the annual gift tax exclusion and the unified gift and estate tax credit to transfer assets to the next generation.
- Allows single-level taxation, avoiding corporate double taxation and the restrictions and complexities of regulations applying to S corporations.
- Avoids the higher income tax rates that apply to trusts.
- May receive minority interest and lack of marketability valuation discounts for gift and estate tax purposes on the value of transferred partnership interests.

Valuation Discounts

The possibility of obtaining valuation discounts is one of the primary reasons for the interest in FLPs. Establishing the amount of the discount requires a professionally prepared valuation. Discounts arise in FLPs for several reasons, including:

- Lack of control. The limited partnership interest has no direct ownership in the underlying assets of the partnership and no ability to control income distribution or asset liquidation and distribution. This lack of control reduces the value of these interests to a certain extent.
- Lack of marketability. The limited partnership ownership interest cannot be converted to cash in any current public market.

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This reduced liquidity is characteristic of a limited partner ownership interest, even though the underlying assets of the partnership might have greater liquidity. Frequently, partnership agreements further restrict the limited partners by controlling the assignment or sale of their limited partnership interests.

These restrictions can give rise to a reduced value—and a benefit to your estate. However, the importance of the documentation of the basis a valuation analyst uses to determine the amount of the discount cannot be overstated. There is no such thing as a “standard discount.” Courts have emphasized the importance of comparable sales and application of the specific facts and circumstances of the case to determine the amounts of these discounts.

Get Expert Advice

When setting up an FLP, retaining a well-qualified valuation professional is critical. Equally critical is an attorney knowledgeable in both federal tax law and state partnership law. Many aspects of structuring an FLP fall within the domain of an attorney. For example, one important issue is whether the partnership agreement is more restrictive than state partnership law. Make sure your FLP is set up to meet all requirements and provide maximum benefit to you and your heirs.

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Add a Valuation

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or rules of thumb to estimate their business' value, this can be risky. For instance, a small business owner may base his or her company's stock prices on the business' average earnings over a period of years, using either a weighted or simple average. But this may not cover all the bases, and a business owner typically doesn't have the requisite training and skills to perform an adequate valuation.

The fact is that a business valuation won't stand up without all the components. To arrive at a reasonably accurate final number, a professional valuator must consider cost, income and market data, though one or more methods may be eliminated if inappropriate to the situation. Failure to consider all factors without a valid explanation can result in an IRS challenge.

What Is Your Interest?

When an estate planning strategy involves a business valuation, you need to be very clear about the business interest being valued. Commissioning a valuation of the entire company then arbitrarily dividing it into segments could distort the results and leave heirs facing unplanned consequences. These consequences can stem from the change in per-share value if a business is divided among several children rather than only one. The potential of a swing vote situation, where a third small shareholder can influence a company's decisions when two large shareholders disagree, may also affect the value of any shares you are giving to family members.

An Effective Tool

A professional valuation can be an effective planning tool for estates that include a business interest—helping to build a sound financial foundation for you and your heirs.

An Important Message

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