How to keep the family business in the family

The American Family Business Institute, an advocate for small businesses, has long argued that the burden of death taxes (estate and inheritance taxes) impairs the ability of keeping family businesses going after the death of the founder. They note that 70% of family businesses do not survive to the second generation, and 90% fail to reach a third generation. A recent study by the American Family Business Foundation concluded that repealing the estate tax entirely would add $119 billion to GDP and increase the incomes of American workers by $79 billion. Another study, by the former director of the nonpartisan Congressional Budget Office, Douglas Holtz-Eakin, found that death tax repeal would create 1.5 million small business jobs and decrease the national unemployment rate by nearly one percent.

Legislation to repeal the federal estate tax permanently is unlikely any time soon, given the new permanence of the $5 million federal exemption (inflation-indexed to $5.34 million in 2014). The higher exemption is welcome, but probably not sufficient for many family businesses to stay in business. Business owners are going to have to take action if they want to gain control over their death tax exposures. That's what the Wandry family did.

Gifts of partial interests

Joanne and Dean Wandry created a limited liability company (LLC) to facilitate giving gifts to their heirs. On January 1, 2004, each of them gave to each of their four children $261,000 worth of units in the LLC. They gave $11,000 worth of units to each of five grandchildren as well. At that time, the annual gift tax exclusion was $11,000 and the lifetime federal gift tax exemption was $1 million. Thus, Joanne and Dean fully utilized these legal protections and owed no gift tax.

The exact number of LLC units (similar to shares of stock) covered by those dollar amounts was not determined at that time, but was to be calculated by an independent third-party professional at a later time. Most importantly, the document executing the gift also provided for an adjustment in the number of units in the event of an IRS audit.

When the $1,099,000 worth of gifts was reported on the federal gift tax return, the attached schedule described the children's interests as a 2.39% LLC interest, and the grandchildren's as a 0.101% interest. Upon audit, the IRS determined that the LLC was worth more than reported, so the 2.39% interest and the 0.101% interest were worth more as well. Enough more to trigger the requirement for a gift tax payment.

Careful lawyering

The Wandrys contended instead that the 2.39% and 0.101% fractions should be reduced until they matched the dollar amount of the intended gift. In an important Tax Court decision earlier this year, they won their point.

When stipulations have been attached to gifts that attempt to void or partially reverse a taxable gift in the event of an IRS audit, those stipulations have been held to be without effect for gift tax purposes. The Tax Court found that the improper "savings clauses" were not the same as the "formula clause" used by the Wandrys. A formula clause is permissible. The key difference is that no property is taken back with a formula clause. Although the value of each membership

unit was unknown on the date of the gift, the value of a membership unit on any given date is a constant, and it is not changed by the revaluation of the firm as a whole upon audit.

The importance of the decision

This is the first time that the Tax Court has approved what estate planners call a “defined value” gift formula. With assets that are hard to value, such as an interest in a family business, it can be tricky to make a gift of so exact an amount. A defined-value clause may resolve this problem in appropriate circumstances.

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Any developments occurring after January 1, 2014, are not reflected in this article.