Passing the baton and preserving the asset: Closely held business interests

Mr. Cabot (all names fictitious) and two longtime business associates own an apartment complex. Cabot has been an active, hands-on partner in the business, and his share of the net income from the partnership is about $500,000 annually. The asset itself represents a substantial portion of Cabot's net worth. Upon Cabot's death part of his interest can be passed to his heirs, and the balance will be bought out by the partnership.

Cabot's son Tom is the general manager for the property, and Cabot's wife and other child (Michael) have no role in the business. Cabot was instrumental in building up the business and only recently has reduced his role in its day-to-day operations. Cabot wants Tom to retain his interest in the business, yet also wants income preserved for his wife and Michael. How can these goals be accomplished in the most tax-efficient manner?

Transfer of a closely held business

When it comes to estate planning, closely held business interests often present the greatest challenge: How can the asset be passed to heirs, income generation be preserved, and liquidity provided to cover estate tax liabilities. Although the estate tax exemption amount and the marital deduction amount can provide tax relief, the real dilemma is getting the asset into the hands of children and grandchildren, without the erosion caused by a huge tax bite.

Experienced estate planning and tax practitioners know that by structuring the ownership of a closely held business in the form of a *limited partnership*, or a corporation with different classes of stock (voting and nonvoting), two benefits result. First, the ownership of the interest can be divided in a way that parallels the business operation itself. Voting shares often are given to those who built up the business or who are active in running the day-to-day operations. Nonvoting interests are given to other heirs or beneficiaries who share in earnings generated by the business, but who have no say in its operations. This methodology can lead to a substantial valuation discount for those who inherit business interests and have no say in business operations.

Many threads weave into a proper estate plan for closely held businesses. In particular, expert advice is needed to:

- Determine the best form of business operation for a particular business; it could be an LLC, LLP, S Corp., C Corp or trust;
- Carve up business interests to reflect accurately the shares of those who work in the business and those who do not;
- Understand any business agreements among owners (including nonfamily partners) that provide for buy-out/cross-purchase of an owner's interest at death;
- Ensure that the valuation method for buy-out purposes will be respected for estate tax purposes as well; and
- Draft documents (wills, powers of attorney, trust agreements, etc.) that ensure that the estate plan is properly implemented.

A solution for Cabot

With guidance from an expert tax advisor, Cabot transferred his interest in the partnership to a Limited Partnership. The limited partnership had as its *general partner*, an S corporation, which was owned by Cabot and Tom, the son who worked in the business. By retaining a general partnership interest, Cabot and Tom maintained control over day-to-day operations. Cabot and family also received limited partnership interests. Cabot gifted interests to his wife, taking advantage of the unlimited marital deduction. The Cabots also made joint gifts of limited partnership interests to their children, which used up the Cabots' present unified credit.

Under the plan the asset, now carved up as limited partnership interests, was passed to Cabot's wife and children, while Cabot and Tom retained general partnership interests and day-to-day control. By structuring the transfer of the rental property interest to the limited partnership, and creating a corporate general partner (capitalized by Cabot and Tom), several benefits were provided:

- A substantial valuation discount is available;
- The stage is set for Mr. And Mrs. Cabot to make ongoing annual gifts of their retained limited partnership interests to children or grandchildren, taking advantage of the annual gift exclusion; and
- The value of the rental property interests is frozen, and any future appreciation in the property is in the hands of the holders of limited partnership interests and no longer taxable in Cabot's estate.

Points to keep in mind

As a business owner passes the baton, estate planning issues often are shrouded with emotional soul-searching. Because the asset often represents an individual's life work, more than just taxes and providing for loved ones is involved. For example, planning can bring other issues to the surface. Issues involving remaining business partners come to mind, for example. A knowledgeable advisor is needed, one who can keep everyone on course as plans are formulated to facilitate business, tax and income-generation objectives.

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Any developments occurring after January 15, 2007, are not reflected in this article.