Individual Tax and Business Planning Articles, Valuation Discounts:

The Impact of Mandatory Tax Distribution Clauses, Crummey-Type Powers and Other Factors

July 25, 2012

By: Martin M. Shenkman, CPA, MBA, JD
Deborah A. Schuman, Partner at MPI
Mark E. Lingerfield, ASA, Partner at MPI
Todd G. Povlich, ASA, Partner at MPI

As 2012 marches on, clients are pushing to complete gift transactions to utilize what remains of their $5.12 million applicable exclusion, establish trusts to, hopefully, grandfather grantor trust status and allocate their remaining GST exemption, all of which have been proposed for modification or worse. Another planning elixir sought by many taxpayers is the gifting of assets that qualify for valuation discounts because of the many proposals to restrict or eliminate discounts. When evaluating these discounts a host of tax and intra-family issues must be considered.

Tax Clauses Important to Evaluate with the Massive 2012 Wealth Transfers

Many operating agreements for limited liability companies (LLCs) and family limited partnerships (FLPs) include a mandatory distribution clause. Similar provisions can be incorporated into S corporation shareholder agreements and with approximately 2 million S corporations still in existence, this remains an important consideration. While a distribution clause can take a variety of forms, a common approach is to mandate a distribution of taxable income on a percentage basis. That percentage might be pegged at a fixed or formula rate. The formula might be the maximum federal income tax rate, increased by some percentage, i.e., three percent, to provide some consideration for the net impact of state income taxes on the members or partners. A new issue might arise depending on the wording of such formula as to whether the reimbursement will require a greater payment in 2013 to reflect the 3.8 percent Medicare tax that will apply to net investment income (Code Sec. 1411)

These clauses are of growing importance as more wealth is shifted into perpetual trusts and down the generational line. Clients considering massive inter-vivos wealth transfers in 2012 should carefully evaluate the pros and cons of including such clauses in the governing instruments for entities whose interests are subject to gift planning. Will the manager of an LLC, or the general partner of a FLP, make reasonable distributions if it is not mandated? Will sibling rivalry be exacerbated by empowering one sibling in the position of manager of a family LLC to determine distributions? Should the less vocal (in terms of personality), or more passive (in terms of the governing instruments) child be at the risk to cover the tax costs of phantom income he or she must report from a family entity? What will the impact be of an investment adviser (or investment trustee) in a dynastic trust on the distributions from the entity in which that trust owns interests? The answer to the latter question is opaque at best given the relative newness of these positions (commentators cannot even agree if a trust investment advisor is a fiduciary or not) and the relative dearth of law on the matter.

Recognizing the lack of cohesiveness of many client families, a tax reimbursement or minimum distribution clause can be of tremendous importance to minimize at least one trigger for family disputes. But as the old adage goes "there is no free lunch." What impact will using a tax reimbursement clause to minimize family strife have on the tax beneficial discounts so many clients are seeking in their 2012 transactions?

Illustrative Tax Distribution Clause

The following is a sample tax reimbursement clause that illustrates several of the potential issues such a clause might address. To illustrate the economics of tax loss harvesting, let's start with a simple example.

- **Tax Distribution Generally**: The Company shall distribute with respect to each Membership Interest, on a quarterly basis on or prior to the 5th (or next succeeding Business Day if the 5th is a Saturday, Sunday or National holiday) of each of April, June, September and December of each calendar year or more frequently, an amount (the "Tax Distribution") in cash equal to the excess, if any, of (i) such Member's Cumulative Tax Liability over (ii) the amounts previously distributed pursuant to this provision during such calendar year.

- **Compensation Not Considered**: For purposes of computing a Member's Tax Distribution under this provision, salaries, bonuses, and any other payments in the nature of compensation to the Member shall not be taken into account, other than as an expense of the company.

- **Exclusion**: No Tax Distribution shall be made in connection with the complete liquidation or dissolution of the Company.

- **Cumulative Tax Liability**: For purposes of this provision, a "Cumulative Tax Liability" means, with respect to any Member, the product of: (i) the cumulative excess of taxable income over taxable losses of the Company for the calendar year allocated to such Member pursuant to this Agreement and (ii) the Deemed Tax Rate which shall be the maximum federal income tax rate for the calendar year, increased by Four Percent (4%).

- **Tax Audit**: If the income allocated to a Member is adjusted on audit and there is a final determination that the share of the Company's taxable income for a particular year that is allocated to such unit is greater than the amount initially allocated to such Member by the Company, the Company shall distribute an amount equal to the Deemed Tax Rate with respect to such Member, multiplied by the increase in taxable income allocated to such Member. If the income allocated with respect to a Member is adjusted on audit and there is a final determination that the share of the Company's taxable income with respect to a Member for a particular year is less than the amount initially allocated with respect to such Member, the Company shall deduct from the Tax Distributions made to that Member an amount equal to the Deemed Tax Rate with respect to such Member, multiplied by the decrease in taxable income allocated with respect to such Member.

- **Tax Distribution if Membership Interest Transferred**: If a Membership Interest is transferred, Tax Distributions for the calendar quarter in which the transfer occurs shall be apportioned between the transferor and the transferee in accordance with the Company's estimated taxable income or loss during the applicable period of ownership, as determined in the sole discretion of the Accountant.

Discount Overview

If an LLC operating agreement requires a 45 percent distribution of quarterly profits to provide cash flow for members to pay their quarterly income tax estimates, how does this affect discounts for valuation purposes? Such a tax distribution clause provides some certainty for members of near term liquidity relative to a similar LLC with no such clause to meet their pass-through tax liability. On the other hand, many LLCs make such distributions to members even without a tax distribution clause. Therefore, the terms of the operating agreement must be reviewed as well as the history of how the LLC has made distributions. To understand the impact that inclusion of a tax reimbursement clause in a governing instrument will have on discounts, an overview of the discount process will provide a helpful framework.

Public Company Restricted Stock Paradigm

One approach to a discount determination, in the context of liquidity and marketability, is to begin the analysis with a paradigm of a public company issuing restricted stock. What would the discount be for such restricted stock relative to its freely traded counterpart? This differential can provide a starting point in the analysis of a discount for lack of liquidity and lack of marketability for a privately held company. There are numerous studies that attempt to identify this discount. The latest Management Planning, Inc. (MPI) Restricted Stock Study takes this process to the next level by using statistical analysis to develop a time, market and company specific discount that takes into account factors including size, market volatility, company volatility and treasury yields, among others.

Adjusting the Public Company Discount to Reflect a Privately Held Company

Once a baseline public company restricted stock discount is determined, the appraiser must evaluate the differences between the subject private company and the public entities that are selling restricted stock. There are a number of factors to consider in this comparison in order to translate the baseline public company restricted stock discount into one that is appropriate for the subject private company. Factors to consider include:

- The provisions of the operating agreement;
- Rights of first refusal;
- Withdrawal, redemption and transfer limitations;
- Lack of information availability;
- Inability to pledge or hypothecate the interest;
- The existence of a buy/sell agreement or put provision;
- Whether or not the company is in financial distress;
- Distribution/dividend policy; and
- Whether or not the entity has a stated term or an expected exit or liquidation date.

For example, most private company owners never anticipate selling the company or having its equity interests registered so that they can be sold in a public market. Conversely, given today's rules, restricted stock can generally be sold in the public market in as little as six months from its initial issuance. Therefore, all else being equal, it follows that private company stock is generally less liquid and less marketable than restricted stock because there will be no public market into which the stock could be sold in six months.

Liquidity Considerations Affect the Private Company Discounts

A critical factor in the discount analysis is the degree of liquidity available to the owners of the subject privately-held entity. The facts and governing instrument provisions can appear in a myriad of variations. There is no specific quantitative analysis for most of the items below; rather they are part of a qualitative analysis. Consider the following:

- If there were no distributions being made from the subject pass-through entity, and there was taxable income generated to the equity owner (i.e., income to report on the Form K-1 for the partner, member or S corporation shareholder), the equity owner would consider this to be a substantial negative in the valuation of the entity, as the owner would be required to come out-of-pocket to satisfy the tax liability. • A tax distribution clause is one factor to consider in an analysis of relative liquidity, but certainly not the only factor. It is especially important if the entity has followed the tax distribution provision for a number of years. This would likely result in a somewhat lower discount than an entity that did not have such a provision. Bear in mind that too often the provisions in governing documents of closely held businesses are observed more in the breach. Thus, even a strict mandatory tax distribution provision, if historically ignored, may have little impact.
- Compare the above scenario of an entity with a mandatory tax distribution provision to a similarly situated entity that does not have such a clause in its governing agreement, but has a history of making regular distributions to meet equity owners' personal income tax obligations. This entity's discount might be lower than an entity with a mandatory tax distribution provision that was not followed. In short, the analyst must observe the historical pattern of distributions when determining the appropriate liquidity discount.
- Some entities may have a history of distributions that exceed what might be construed as tax distributions. One way of accounting for such excess distributions is through an S corporation (pass-through entity) premium analysis. In contrast to many of the matters noted in this discussion that are more qualitative adjustments, there is a specific quantitative analysis for the pass-through entity benefit. The MPI S corporation premium analysis generally measures the "tax shield" associated with any distributions made over and above the actual income tax liability to the owners. In contrast to C corporation payouts, there is no dividend tax levied on distributions from a pass-through entity. Therefore, when excess distributions are made, it is generally considered more beneficial to be an owner in a pass-through entity versus an otherwise equivalent C corporation. The S corporation premium analysis tests whether the structure provides a material and measureable benefit versus its C corporation counterpart. For example, if an entity is only making distributions to cover pass-through taxes and no excess distributions are

being made, a premium is not assigned because the second layer of tax (the dividend tax) is not being triggered.

- Potential liquidity from a future sale may reduce the discount. Any major source of liquidity (whether from excess distributions, or from the expected sale of a division or the entire company) will likely impact the estimation of discounts. If the company is doing well and a potential sale is likely, the impact may be significant. For example, if a private equity or venture capital firm has taken a position in a private company, the outlook for a liquidity event is likely to be much different than for most other private companies. There is a lengthy history of such firms having targeted holding periods for investments (e.g., four to six years) and defined exit strategies (e.g., IPO, sale to a strategic buyer). On the other hand, an indefinite holding period and the lack of expectations for any type of liquidity event is the norm in the private company universe. However, that too must be evaluated on a case-by-case basis.

Crummey-Type Provisions to Qualify for Annual Gift Exclusion

Some FLPs or LLCs include a provision analogous to a Crummey power that would afford a donee of an equity interest, a limited the right to sell the interest received as a gift (or to put it back to the entity). This is done to endeavor to qualify a gift of equity interests for the annual gift exclusion. This requires that the gift not be of a future interest, but rather a present interest for which the donee can currently realize an economic benefit. The restrictions on transferability and distributions that many families insist on including in their FLP or LLC governing documents to keep equity within the family can contradict the requirements of qualifying as a gift of a present interest. So, some commentators have postulated that including something in a partnership or operating agreement that is analogous to the annual demand or Crummey powers long used in insurance and other trusts, might solve the issue. But, just as for the tax reimbursement clause, the issue arises as to what impact this might have on the discounts so many clients are endeavoring to maximize?

The key issue in determining the impact of these demand or put rights is whether they would affect a willing buyer of equity interests in that entity. If they would, then these provisions would adversely affect valuation discount. However, it is not clear that in all cases they would. Bear in mind it is the hypothetical willing buyer/seller that is the litmus test and this type of provision might be unique to the particular donee of the interest. While any conclusion will depend on the actual language in the governing document, it seems feasible that in some instances these Crummey-type rights may be disregarded and, thus, not impact discounts.

Conclusion

Gift planning in 2012 introduces a host of complex issues that practitioners must evaluate. Too often clients focus exclusively on tax issues, such as maximizing discounts. This one-dimensional emphasis may increase as the 2012 planning window closes. Practitioners should endeavor to direct clients to consider the myriad of personal implications of this planning, mandatory tax distributions being but one. Critical to successfully planning for such issues is the fact that many of the decisions are inextricably interconnected. Tax distribution clauses can help maintain some family equanimity, but assuming that such distributions are actually made, the discounts that drew clients to the planning table may be somewhat reduced to account for modest liquidity provided by such distributions.

About MPI

MPI is a business valuation and advisory firm that was founded in 1939. MPI provides business valuation and advisory services primarily to closely held companies and partnerships for a variety of purposes including estate and gift tax, income tax, charitable contributions, litigation support, buy-sell agreements, ESOPs, and exit planning. MPI provides fairness opinions, sell-side and buy-side advisory services, intangible asset valuation, purchase price allocations, goodwill impairment testing, valuations for equity-based incentive plans, and blockage and restricted stock studies. MPI conducts every project as if it is going to face the highest level of scrutiny, and its senior professionals have extensive experience presenting and defending work product in front of financial statement auditors, management teams, corporate boards and fiduciaries, the IRS, other government agencies, and in various courts.

Please visit www.mpival.com for more information on our valuation and advisory services.