

Shielding the Family Business

By LAURA SAUNDERS Updated April 30, 2012



Small-business owners often complain of feeling caught in the cross hairs of the tax code. For a change, here's good news.

The Tax Court has just blessed a new technique that owners of closely held businesses—and wealthy families—can use to pass assets to heirs with a minimum of taxes and complications. The ruling in the case, *Wandry v. Commissioner*, is stirring up excitement among experts.



Lee Hasler

David Kautter, a director of American University's Kogod Tax Center, calls the ruling a "landmark decision, because it allows tax-free ownership transfers from one generation to another with certainty and in an orderly manner."

Here is why *Wandry* matters. Our current system imposes a gift tax of up to 35% when taxpayers give assets away, with exceptions. Individuals now get one \$5.12 million lifetime exemption, and they can also give up to \$13,000 of assets a year to an unlimited number of recipients. (Next year the lifetime break is scheduled to drop to \$1 million and the top rate to rise to 55%.)

This means an owner who wants to give a business to children or others, such as employees, can use these exemptions to transfer ownership tax-free. He can even use the \$13,000 annual exclusion to transfer value bit by bit.

That is what happened in the *Wandry* case. Dean and Joanne Wandry, a Colorado couple, each gave units in a family-owned limited-liability company worth \$1,099,000 to their heirs in 2004. To avoid paying tax, they specified the gifts should equal the dollar amount of their exemptions—a key point. (At the time, the lifetime exemption was \$1 million and the annual exclusion \$11,000.)

The hitch in *Wandry* and other cases is that the givers have to get a professional appraisal if—as is common—the company is hard to value. Often values are lowballed a bit in order to maximize the

gift. But the Internal Revenue Service can contest the appraisal after the gift—and often does. In Wandry, the value rose about 20%.

That brings up an important issue: If values rise after an IRS challenge, must the giver write a big check for tax on the amounts above the exemption?

According to the Wandry decision, no. The judge held the couple intended to make a gift equal to their exemptions, so the excess was never actually given by them. No tax was due.

Here's a simplified example: John's business is appraised at \$6 million. He gave units worth \$5 million to relatives last year, with more to come in \$13,000 annual gifts over time.

The IRS later determines that the \$5 million of units were actually worth \$6.2 million. Does John owe gift tax of about \$400,000 on the \$1.2 million? Not if he arranges the transaction as the Wandrys did, and the \$1.2 million is deemed never to have been given. It remains John's.

The IRS must feel like this decision stacks the deck in taxpayers' favor, because they don't risk writing a check if they lowball the value of a gift.

According to attorney John Porter of Baker Botts in Houston, Wandry is the latest in a line of related cases lost by the IRS. Absent the Wandry decision, often the best outcome is for a family to designate a charity to receive the excess. No tax is due, but the family gives up some control.

The Wandry case is a boon not only for business owners but also wealthy families with "family limited partnerships" or entities holding publicly traded stocks. Even though the stocks' value is easy to determine, submerging them in a nontraded company provides valuable discounts when units are transferred to heirs.

As a "memorandum" decision, Wandry may be cited as precedent in future cases. The IRS had no comment either on the decision or whether it will appeal the case to the 10th Circuit Court of Appeals.

The catch: The IRS has more than three months to appeal the case. Mr. Porter believes its reasoning is sound, but taxpayers who rely on it while gift-tax exemptions are high and rates are low run a risk.

Still, it may be important to act soon. The decision is so advantageous for taxpayers that it could inspire a response from Congress or the IRS.

Proposals on passing wealth through partnerships that would undercut Wandry have been raised repeatedly by lawmakers, notes Kogod's Mr. Kautter, and the decision could help revive them.