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by Chris M. Mellen

*Accredited Senior Appraiser * Master Certified Business Appraiser*

"Recent Developments in Estate Planning, 2010 – A Valuation Perspective"

Having recently attended the 44th Annual Heckerling Institute on Estate Planning, I have outlined some of the recent developments in estate planning issues *from a valuation perspective* as a reference tool. It is important to note that these are brief notes of very complicated topics and issues that warrant further dialogue with the author or research by the reader interested in further understanding any points made below.

Estate Planning in 2010. As predicted in last year's Conference, events in 2009 were such that it was a good year to transfer assets due to low asset values and interest rates. While both asset values and interest rates have gone up over the past year, they are still considerably lower than they were just a few years ago. What was not predicted was that we would be in limbo in terms of what the Federal estate tax law would be. Will Congress reinstate the Federal estate tax at some point during 2010? If they do, will it be retroactive to January 1, 2010? Will Congress decide during 2010 to create a new estate and generation-skipping transfer tax? Will Congress fail to act during 2010 and let the Federal estate and GST taxes return in 2011 at the levels they were in 2001? The consensus at the Conference seemed to be that nobody really knows. As recently as the last two months of 2009, most people were confident that Congress would do something to avoid this problem before 2009 came to an end. Looking forward, the longer this issue is in limbo, the more difficult it is going to be to reinstate the tax retroactively, both from a legal and political perspective. Also, as time passes, the likelihood of this issue not being addressed increases until we have a lame duck Congress after the elections.

In brief, some of the features of the current law include: 1) the "shall not apply to...decedents dying after Dec. 31, 2009" language of §2210; 2) the "shall not apply to generation-skipping transfers after Dec. 31, 2009" language of §2664; 3) the reduction of the top rate of the gift tax to 35% from 45% for 2010; 4) the §2511(c) rules regarding transfers to non-grantor trusts; and 5) the carryover basis rules that do not permit any step-up but do provide for carryover of basis and potentially for a step-down in basis if the fair market value of an asset is less than the decedent's basis in that asset and the elections to allocate up to $1.3 million (plus NOLs and certain other unused losses) to increase the basis of the decedent's assets up to FMV and to allocate up to $3,000,000 to assets passing to a surviving spouse, either outright or in a QTIP trust.

There may be many estates impacted by the carryover basis in 2010 that would not have been required to file an estate tax return had we continued with a $3.5 million exemption. Congressional officials are estimating that the extension of the estate tax exemption at $3.5 million would have affected 6,000 estates in 2010, but that the carryover basis provisions that are now in place instead will affect more than 70,000 estates.

Valuation Discounts. The Obama Administration proposes to make dramatic changes to the rules pertaining to valuation discounts. If there is no legislation pertaining to the estate and gift taxes, the IRS has indicated that it may issue regulations under §2704 that would significantly restrict valuation discounts on entities that are valued on the basis of their liquidation value (e.g., FLPs or family LLCs holding real estate, marketable securities, or assets other than operating businesses). As a result, coupled with a potentially temporary 35% gift tax rate, wealth advisors and attorneys might consider encouraging their clients to make desired gifts and sales as early in 2010 as possible.

GRATs. The environment in 2009 presented a tremendous opportunity to establish new GRATs. This was due to two factors: low Applicable Federal Rates (i.e., the appreciation of assets in a GRAT in excess of the AFR hurdle passes to beneficiaries tax-free) pursuant to IRC §7520, and significant declines in the value of many assets (i.e., anticipated recovery in value can occur on beneficiaries' balance sheets as the market improves). While the AFR (at 3.4% in February 2010) has come up a bit from its all-time low of 2% in 2009, and the market values of many assets have partially recovered, it is still a good time to establish a new GRAT in 2010.

100 River Ridge Drive, Norwood, MA 02062 • Tel 781.551.8258 • Fax 781.551.0850

cm@delphivaluation.com • www.delphivaluation.com

Overall, if one is thinking of establishing a GRAT, they should not procrastinate. This is due to the fact that, as indicated above, there is a movement to eliminate some estate planning strategies such as GRATs, or at least make them much less favorable. The Treasury Department's "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" ("Greenbook") was released on May 11, 2009. Among its three revenue-raising proposals was an increase in the mortality risk of GRATs by requiring a minimum ten-year term.

In his presentation, Dennis Belcher noted that after reciting the history of §2702 and the use of GRATs, the Greenbook notes that "[t]axpayers have become more adept at maximizing the benefit of this technique, often by minimizing the term of the GRAT (thus reducing the risk of the grantor's death during the term), in many cases to two years, and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero or to a number small enough to generate only a minimal gift tax liability." Thus, the discussion in the Greenbook actually appears to ratify the use of "zeroed-out" GRATs, within the constraint of a minimum ten-year term. A zeroed-out GRAT typically works best when the annuity term is short (i.e., two or three years) and the GRAT is funded with one stock. The owner can use a GRAT to try to shift additional stock out of his or her estate, at no tax cost. The stock need only grow at a rate exceeding the AFR for the GRAT to have some benefit.

The focus seems to be more on the effect of the proposal in increasing the mortality risk of a GRAT, not its arguably more significant effect in diminishing the upside from volatility. One publication notes that even a ten-year GRAT could be used "as a gift tax avoidance tool" and that a ten-year minimum term might encourage the use of GRATs by younger taxpayers. With currently depressed values, difficulty in predicting the timing of recovery, and relatively low interest rates under §7520, many clients have recently been opting for GRATs with terms longer than the typical two years anyway. But requiring a minimum ten-year term will encourage more customizing of the terms of a GRAT, including greater use of level GRATs or GRATs in which the annuity increases in some years but not others or increases at different rates in different years.

Defined Valuation Clause. This clause can guard against retroactive changes in the valuation method and limit additional gift tax exposure in an audit if applied properly. For example, a defined value clause may be used where a formula allocates the transferred property between two recipients (e.g., a family member and a charity), where transfers to one recipient are taxable and transfers to the other are not, where the formula caps the value passing to the taxable recipient based on values as finally determined for federal tax purposes. In a reviewed decision in *Estate of Christiansen v. Commissioner, 130 T.C. 1* (2008), the Tax Court unanimously approved a formula disclaimer with reasoning that would also apply to a defined value transfer, thus appearing to support their efficacy (i.e., sanctioned by the Courts). A similar finding came in 2009 in *Estate of Petter v. Commissioner*, T.C. Memo 2009-280. If done properly, any increase in value upon audit would pass to the charity (but not restricted to charities), and would therefore not result in any additional revenues for the IRS, thus being a disincentive for the IRS to pursue. Among its arguments, the IRS argued on public policy grounds that the defined valuation clause would discourage it from examining estate tax returns. The Tax Court rejected this argument, noting that "we are hard-pressed to find any fundamental public policy against making gifts to a charity – if anything the opposite is true. Public policy encourages gifts to charity, and Congress allows charitable deductions to encourage charitable giving." Despite their continued setbacks in challenging the defined valuation clause, the IRS is not close to any acquiescence and plans to continue to push these cases.

Discount for Built-in Capital Gains Tax. Any liability associated with assets that would be the responsibility of either the entity or of its owners, if such liability passes through to the owners, must also be considered in a valuation. In the event of a sale of the underlying assets held by the entity, the capital gains tax would be taxed either to the current limited partners or to any future limited partners. Accordingly, a willing buyer would consider that the purchase of any such interest would require an out-of-pocket expense for taxes in the event of a sale of any or all of the assets. Such a sale of assets could be triggered at any time as far as the willing buyer of a limited partnership interest is concerned, since this interest has no control over the sale of the underlying assets. In *Commissioner v. Estate of Frazier Jelke III*, 507 F.3d 1317 (11th Cir. 2007), the Court, with a dissent, determined that in valuing closely-held stock, a dollar-for-dollar discount for capital gains tax that would be incurred on the

liquidation of company assets is allowed without any reduction for the fact the tax would be paid over a number of years. This is a departure from *Estate of Borgatello v. Commissioner*, T.C. Memo 2000-264, 80 T.C.M. (CCH) 260 (August 18, 2000), where there was an assumption of a certain holding period and annual growth rate, resulting in a lower discount. In *Estate of Litchfield v. Comm'r*, T.C. Memo. 2009-21 (January 29, 2009), the Court allowed a discount for built-in capital gains based upon the assumption that the assets would be sold over time. The estate's expert projected holding periods and estimated sales dates for the company's assets, anticipated appreciation to the sales dates, and discounted the capital gains back to the valuation date; and this approach was adopted by the Court.

Nevada Restricted LLCs/LPs Present Additional Valuation Discount Opportunity. Effective October 1, 2009, "restricted" limited liability companies and limited partnerships (hereinafter referred to as "restricted LLCs") were created in Nevada pursuant to Nevada Senate Bill 350 and NRS 86.161. This law takes advantage of an exception in Internal Revenue Code §2704(b)(2) which provides that, if there is a transfer of an interest in a corporation or partnership to a member of the transferor's family, and the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, any "applicable restrictions" shall be disregarded in determining the value of the transferred interest. The term "applicable restrictions" refers to any restriction on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction.

Through this legislation, an ordinary Nevada LLC can elect to be "restricted" in terms of having limitations on its ability to make distributions to its members. Under this statute, a restricted LLC shall not make any distributions to its members with respect to their membership interests until ten years after the LLC is formed or is amended to become a restricted LLC, unless otherwise provided in the articles of organization. Thus, there is flexibility. The ten-year restriction, for example, is a ceiling. As such, the underlying assets can be locked up for a fewer number of years. Also, the LLC may allow for a discretionary right to distribute a certain amount per year, say, to pay any income tax liability. There is also flexibility to coordinate distributions with the annuity payments in a GRAT if units of a restricted LLC are being gifted to that GRAT. Finally, a resident of any state can opt into these Nevada laws by setting the entity up in Nevada.

From a valuation perspective, this default statute locking in a restricted LLC's underlying assets for up to ten years, creates a situation where considerably higher valuation discounts, likely in the double digits, are appropriate on top of what is applicable without this additional provision. As of the writing of this article, this type of statute does not exist in any other state. Therefore, such restrictions would be disregarded in an entity set up in any other state for valuation purposes. It is important to note that while generally respected by the IRS, the choice of state law by entities other than the state in which the entity's business is conducted or its assets are located may be challenged if the non-tax objective could have been accomplished in the state of residence.

To learn more about this legislation, visit the website page developed by attorney Steven J. Oshins – http://www.oshins.com/restrictedllcandlp.html. Bill 350 can be read online at http://leg.state.nv.us/75th2009/Bills/SB/SB350_EN.pdf. The Restricted LLC language can be read in Sections 26 and 27 of the Bill. The Restricted LP language can be read in Sections 38, 39 and 49.2 of the Bill.

Recent Tax Court Cases. Some of the Tax Court cases involving valuation issues in 2009 include the following:

1. *Estate of Litchfield v. Comm'r*, T.C. Memo. 2009-21 (January 29, 2009) was discussed above in the section on the discount for built-in capital gains tax.
2. In *Estate of Jorgensen v. Comm'r,* TC Memo 2009-66 (March 26, 2009), the Tax Court (Judge Haynes) addressed the questions of: (1) whether value of assets transferred by the decedent to two family limited partnerships holding marketable securities should be included in her gross estate under §2036(a); and (2) whether the estate is entitled to equitable recoupment of capital gains tax paid related to the sale of asses of those partnerships. The Court noted that "it would be inequitable for the assets to be included in the value of Mrs. Jorgensen's estate under §2036 on the one hand, and on the other hand for the estate not to recoup the income taxes her children and grandchildren overpaid on their sale of those very same assets but are

unable to recover in a refund suit." The Court also pointed to post-death payments of estate taxes as reflecting an implied agreement of retained enjoyment of partnership assets to trigger §2036. As such, the IRS won this case.

3. In *Estate of Miller v. Comm'r,* TC Memo 2009-119 (May 27, 2009), the Tax Court (Judge Goeke) was asked to determine: (1) whether assets in a QTIP Trust from which the decedent received no distributions must be included in her gross estate; and (2) whether §2036 applied to include in the decedent's gross estate assets (marketable securities) transferred by her to a family limited partnership: (a) upon formation; and (b) approximately one year after formation. The Court held that §2036 did apply to include the May 2003 contribution of assets in Mrs. Miller's estate. This was a "mixed results" case in that the early contributions satisfied the *bona fide* sale exception, but the additional contributions made days before death did not.

4. In *Heckerman v. United States*, U.S. Dist. Ct., Cause No. CO8-0211-JCC (W.D. Wash. July 27, 2009), the Court, granting the Government's motion for summary judgment, held that contributions of cash to an LLC and gifts of interest in the LLC on the same day should be treated as indirect gifts and as violative of the step transaction doctrine to eliminate valuation discounts for gift tax purposes. The transfer of assets to the LLC and gifts of interests in the LLC were made on the same day and the taxpayers could not prove which happened first, precluding any discounts for gift tax purposes.

5. In *Linton v. United States*, 638 F. Supp.2d 1277 (W.D. Wash. 2009), the district court held in summary judgment proceedings that the taxpayers' transfer of property to an LLC on the same day that gifts of LLC interests were made to a trust for their children resulted in indirect gifts of the underlying assets, again precluding any discounts for gift tax purposes.

6. In *Rayford L. Keller, et al. v. United States of America*, Civil Action No. V-02-62 (S.D. Tex. August 20, 2009), the district court recognized a family limited partnership even though it had not been funded before the decedent's death. The court also found that the *bona fide* sale exception to §2036 and §2038 applied because: (1) the FLP demonstrated a legitimate business purpose (protecting family assets from divorce proceedings and facilitating the administration of family assets), (2) the partnership was genuine, and (3) the decedent retained significant assets outside of the partnership. With respect to valuation issues, the Court accepted the taxpayer's valuation analysis which concluded on a combined discount for lack of control and marketability of 47.5 percent (the underlying assets were securities). The court rejected the IRS's valuation expert's opinion because it violated the willing buyer/willing seller test, including consideration of the true identities of the buyer and seller, speculating as to future events (citing *Estate of Simplot*), and aggregating the interests of the various owners (citing *Estate of Bonner*).

7. In *Pierre v. Comm'r*, 133 T.C. No. 2, No. 753-07, 2009 WL 2591625 (Aug. 24, 2009), the Tax Court addressed the question of whether interests in a single member limited liability company (treated as a disregarded entity under §7701) should be treated for gift tax purposes as transfers of proportionate shares of the underlying assets owned by the LLC or as transfers of interests in the LLC. The Tax Court rejected an IRS attempt to disregard the LLC for gift and estate tax purpose because it is a "disregarded entity" for income tax purposes.

8. In *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009), the Federal District Court for the Western District of Arkansas addressed a refund claim involving the IRS's attempt to apply §2036 to the assets contributed by the decedent to a family limited partnership. With respect to valuation, the Court adopted the taxpayer's expert's conclusions of discounts for lack of control and marketability. On the discount for lack of control, the Court found that the estate's appraiser's application of a 12.5 percent discount was more credible because he appropriately screened funds and used closed-end funds that were more similar to the partnership's asset categories. On the discount for lack of marketability, the Court adopted the estate's expert's 32.5 percent discount rather than the IRS's expert's

10 percent discount. The court noted that the estate's expert's approach, which compared data from various specific restricted stock studies to the holding period, relative risk and distribution policy, and transfer restrictions applicable to Mr. Murphy's LP interest, was more credible than the approach applied by the IRS's expert. Specifically, the Court noted that the estate's expert appropriately determined that the holding period for Mr. Murphy's LP interest was substantially longer than that of restricted stock (one to two years). Thus, the combined discount was approximately 41 percent.

With regard to other Tax Court cases, seven years ago, I published an article "IRS Challenges to Pass-Through Entities" in *Business Valuation Update* as well as in Delphi's *Valuation E-Column*. I have since updated this article to reflect relevant cases through the middle of 2009 (and will make this available to the reader upon request). Several Tax Court opinions have dealt a significant blow to many of the arguments made by the IRS (e.g., lack of economic substance, lack of business purpose, IRC §2703, IRC §2704(b), and gift on formation). However, as is widely known, the IRS has been successful on many occasions with its §2036 argument that the partners/members in an LP/LLC did not respect the entity and treat it as a separate legal entity for state law purposes. As such, as noted by John Porter in his presentation on valuation issues, the following questions (first nine relating to formation and latter six relating to operations) should be addressed to ensure the IRS does not have a valid argument in a given case:

1. What are the non-tax reasons for creating the entity?
2. To what extent did other partners make real contributions of property or services?
3. Does the client setting up the entity have sufficient assets outside it on which to live? Are there enough proceeds to pay estate tax liabilities outside the family limited partnership?
4. Are personal assets being placed in the entity?
5. Are financial obligations being properly followed?
6. Do *all* partners have the opportunity to comment on and provide input with respect to the terms of the agreement?
7. Do *all* partners have the opportunity to decide what assets would be contributed to the entity?
8. What is the discretion regarding distributions provided to the general partner?
9. Is there adequate time between the date of funding and the date of transfer, and has it been sufficiently documented?
10. Are the non-tax reasons for creating the entity consistent with how it is being operated?
11. Are partnership assets being commingled with the general partner's personal assets?
12. Are distributions being made in accordance with the terms of the agreement?
13. Is the entity being treated and respected as a separate entity?
14. Are personal expenses being paid from the partnership?
15. Are taxes and/or non-partnership expenses being paid directly out of the partnership?

In closing, there is a lot in flux in the estate planning arena. With change comes additional planning. The 45th Annual Heckerling Institute, to be held on January 10-14, 2011 in Orlando, will likely bring with it the discussion of many new developments.

Valuations form the foundation of transactions and many business, estate, financial reporting, litigation, strategic, succession, and tax plans. If we can provide additional information or advice on a current situation, please call us. *Delphi Valuation Advisors, Inc. Values Your Business!*

Chris M. Mellen, ASA, MCBA, CM&AA, MBA
President – Delphi Valuation Advisors, Inc.
Boston Affiliate of the **American Business Appraisers®** National Network

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