# V. VALUATION OF ASSETS FOR ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAX PURPOSES

## A. Introduction

This Chapter discusses the rules for the valuation of assets for estate, gift, and generation-skipping transfer ("GST") tax purposes. The valuation rules are important because they play an integral role in determining the amount of estate, gift, and generation-skipping transfer tax due on the lifetime and testamentary transfer of assets. The Treasury Regulations (the "regulations") provide a general definition of fair market value and specific valuation rules for certain assets.

The valuation of assets can also play an important role in planning for the disposition of assets during life and upon death. Certain techniques can be implemented to decrease the value of an asset prior to its disposition in order to reduce any gift or estate tax liability. Such techniques use fractional interest discounts, minority interest discounts, lack of marketability discounts and discounts on capital gains as a device to decrease the value of an asset. The topics that will be covered in this Chapter include:

- Fair market value
- Valuation date and alternate valuation date
- Specific valuation rules for certain assets
- Valuation of real estate
- Business interest discounts
- Chapter 14 valuation rules regarding certain rights and restrictions
- Minimizing valuation risks for lifetime transfers

## B. Fair Market Value

### 1. General Definition

The primary purpose of the regulations dealing with valuation is to provide guidance in determining the fair market value of property at the valuation date. As a general definition, the Regulations set forth fair market value as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Treas. Reg. §§ 20.2031-1(b); 25.2512-1. This definition allows for positive and negative factors to be considered in the valuation of an asset much like a willing buyer and willing seller would do. For example, accrued interest will increase the value of an asset while an accrued tax liability, such as unrealized capital gain, will decrease the value of an asset.

All relevant factors that may affect value are to be considered. A relevant factor includes the fact that the decedent died. For example, a life insurance policy payable on the decedent's death is included in the decedent's estate at the full death benefit value because the value of the death benefit is not affected by the decedent's death. However, if the decedent was a "key- person" of a closely-held business and the business suffered a loss due to the death of the decedent, the value of the business may be discounted to allow for the effect of the decedent's death on the

business.

➔ **Planning Point:** The effect of the decedent's death should be taken into account in the valuation of assets that relied heavily on the talents and skills of the decedent. The decedent's death can affect the value of the property positively or negatively depending on the type of asset. Such assets include closely-held businesses, works of art created by the decedent, and intellectual property composed by the decedent. Intellectual property and works of art can increase in value because no other creations will be produced by the decedent. Whereas, a closely-held business can decrease in value if the decedent played a major role in the operations and success of the business.

**2. Actual and Comparable Sales**

**a. Actual Sales.**

**(1) General Rule**. Since fair market value is defined as the price that would be paid by a willing buyer to a willing seller, an actual bona fide sale of the property generally will be the best evidence of fair market value. For an actual sale to be a factor in the determination of fair market value, it must be a bona fide sale within a reasonable period of time of the valuation date. Additionally, there should not be any circumstances between the sale and the valuation date that would affect the property's value.

> **EXAMPLE:** If the property was severely damaged after the valuation date and then sold at a reduced price, the actual sale would not be a significant factor in the determination of fair market value.

**(2) Reasonable Time**. The definition of "reasonable time" varies widely and depends primarily on the facts and circumstances of each case. If the market fluctuates considerably between the valuation date and the actual sale date, the actual sale may be disregarded. As a general rule, the passing of a few years, even in a stable market, will be regarded as an unreasonable amount of time. *Estate of Krischer v. Comm'r.*, T.C. Memo 1973- 172 (Tax Court held that seven years was too much time to find an actual sale useful). The passage of less than two years in a stable market tends to be regarded as a reasonable time. *Estate of Helen M. Noble v. Comm'r*, T.C. Memo. 2005-2 (sale by estate of closely-held stock approximately 14 months after the decedent's death occurred within a reasonable time when there were no intervening events that drastically changed the value of the property); *Gettysburg Nat'l Bank v. U.S.*, 806 F.Supp. 511 (M.D. Pa. 1992); *Estate of Kaplin v. Comm'r.*, T.C. Memo 1986-167.

➔ **Planning Point:** Careful consideration should be given before actually selling any asset of an estate to ensure that the ultimate valuation of the property for tax reporting purposes as a result of the actual sale does not cause an adverse tax consequence.

**(3) Forced Sales.** The Regulations state that value is not to be determined by a forced sale. Treas. Reg. § 20.2031-1(b). Therefore, an auction generally is not determinative of value. However, if an auction has a reserve (a minimum price for which the item

can be sold) or if there is a minimum opening bid, the auction price may be used as evidence of value. Rev. Proc. 65-19, 1965-2 C.B. 1002.

**b.** **Comparable Sales**. The sale of comparable property is highly probative as to the value of the subject property. To be comparable, the property sold must be similar to the subject property. There must be a commonality between the two properties that would justify comparing the sales information. Some types of property are more readily comparable than others. It may be easier to find a comparable car than to locate comparable real properties. The job of the appraiser is to take into account the differences between the comparable properties and the subject property and make adjustments to account for the differences. If there are too many differences between the comparable properties and the subject property, the comparisons may not substantiate the value of the subject property.

Additionally, the comparable sale must occur close in time to the valuation date in order to be meaningful or there must be a method for adjusting the value to account for the passage of time. There is not a recognized cut off point when a comparable sale is no longer meaningful. However, as a general proposition, the closer the sale date is to the valuation date, the more meaningful the comparable sale will be in determining the subject property's value.

> **EXAMPLE:** A died on January 1 of year 1, owning a personal residence in State X and owning another personal residence in State Y. There are six comparable sales for the residence in State X. All of the comparable sales are within two blocks of the State X personal residence and all the sales were made within the last two years of the valuation date. There is only one comparable sale for the personal residence in State Y. The comparable sale was made in a county different from that in which the State Y residence is located and occurred 5 years prior to the valuation date. The comparable sales in State X are highly probative in determining the value of the State X residence. However, the one comparable sale in State Y is marginally useful, if at all, in determining the value of the State Y residence. A different approach should be used to value the State Y residence.

## C. Valuation Date and Alternate Valuation Date

### 1. Valuation Date

Generally, the valuation date for estate tax purposes is the date of the decedent's death. Internal Revenue Code ("IRC") § 2031(a). As discussed below, the alternate valuation date also can be used to value assets for estate tax purposes. For gift tax purposes, the valuation date is the date the gift is completed. IRC § 2512(a). There is no alternate valuation date for lifetime gifts.

The valuation date for generation-skipping transfers is the date the transfer is made; although, if the transfer is a direct skip made at death, then the alternate value used for estate tax purposes can be used to value the generation-skipping transfer.

### 2. Alternate Valuation Date

An alternate valuation date can be used to value the assets of an estate six months after the date of death. IRC § 2032. The alternate valuation election may be used only if the election will reduce the value of the gross estate and reduce the sum of the estate tax and GST tax liability (reduced by credits allowable against these taxes). IRC § 2032(c). If an asset depreciates due to the mere passage of time, the alternate valuation date cannot be used. IRC § 2032(a)(3). If the alternate valuation date is elected, all of the assets must be valued as of that date. In other words, the estate cannot choose to value some assets on the alternate valuation date and other assets on the date of death. However, if an asset is sold or otherwise disposed of between the date of death and the alternate valuation date, the actual sale price will be the value of the asset for alternate valuation purposes.

> **EXAMPLE:** A patent and a life estate are examples of assets that decrease in value merely by the passage of time. A patent expires after a term of years. The passage of six months makes the interest less valuable because the term is shortened. Likewise, a life estate is less valuable as the life tenant ages, so the passage of six months will reduce the value of the life estate. The alternate valuation date cannot be utilized if the decrease in the value of the estate is attributed only to those assets that decrease in value merely by the passage of time.

➔ **Planning Point:** The alternate valuation date can be used to reduce the overall estate tax liability on an estate while increasing the value of other assets in the estate, such as a personal residence, thereby increasing the step-up in basis received. As long as the overall value of the gross estate and the estate tax liability decrease between the date of death and the alternate valuation date, individual assets can increase to achieve income tax benefits.

## D. Specific Valuation Rules for Certain Assets

### 1. Stocks and Bonds

**a. General Rule**. As a general rule, stocks and bonds are valued at their price per share on the valuation date. Treas. Reg. §§ 20.2031-2(a); 25.2512-2(a). If the stock or bond is publicly traded, the per share price is the mean between the high and low trading price on the valuation date. If there were no shares traded on the valuation date (*e.g.*, the valuation date is a holiday or weekend), the per share price equals the weighted average of the mean price on the nearest trading day preceding the valuation date and the mean price on the nearest trading day following the valuation date. The average of these two mean prices is weighted by the number of days they are from the valuation date.

> **EXAMPLE:** If A dies on a Saturday and has publicly-traded stock in his gross estate, the price per share will be the weighted average between the mean of the high and low trading prices on the Friday preceding A's death and on the Monday following A's death. Thus, if the mean share price on Friday (which is only one day from the valuation date) is $27 per share and the mean share price on Monday (which is two days after the valuation date) is $36 per share, the weighted average of these two

prices will be $33, calculated as follows: (($27 x 1) + ($36 x 2)) ÷ 3 = $33.

If stocks or bonds are listed on more than one exchange, the exchange that primarily deals in the security should be used. If the securities are not listed on a public exchange, special care should be taken to determine the reliability of the information. The regulations suggest attaching a broker's letter or other credible confirming documentation to the tax return to establish the valuation of unlisted securities. Treas. Reg. §§ 20.2031-2(b); 20.2512-2(b). For a discussion of the valuation of closely-held business interests, see Paragraph 2 below.

b. **Exceptions for Bonds**. Since bonds ordinarily are not traded on a daily basis, the above-cited regulations provide an exception to the general rule stated above. If the only listed price for the bond is the closing selling price, then the value is the mean of the closing selling prices on the valuation date and the trading day before the valuation date. If there were no sales on the trading day before the valuation date, but there are sales on a day within a reasonable period of time before the valuation date, the value is determined by using a weighted average of the closing selling price on the valuation date and the closing selling price on the nearest day before the valuation date. If there was no trading of the bonds within a reasonable period of time prior to the valuation date, the value would be the closing selling price on the valuation date.

If none of the above methods of valuing a bond is available, the value can be determined by the mean of the bona fide bid and ask prices on the valuation date. Alternatively, the mean of the bona fide bid and ask prices on the day before and after the valuation date can be used if there are no bid and ask prices on the valuation date.

**2. Business Interests**

a. **General Rule.** The valuation of a closely-held business interest can be difficult to ascertain because there is no readily available market for the sale of the business interest. While the Internal Revenue Service ("IRS") is willing to accept the trading public's assessment of a company's value in publicly-traded shares, the valuation of a non-traded business interest is scrutinized more closely.

The regulations prescribe the same general rule for the valuation of a closely-held business interest as for any other asset; the price paid in an arm's-length transaction between a willing buyer and a willing seller. Fair market value is determined based upon all of the facts and circumstances, which include (i) a fair appraisal of all assets of the business including intangibles such as goodwill, (ii) the past, present and future earnings of the business, and (iii) the same rules used for the valuation of corporate stock in Treas. Reg. § 20.2031-2, discussed above.

In addition to the regulations, the IRS in Rev. Rul. 59-60, 1959-1 C.B. 237, has set forth its seminal pronouncement for the valuation of a closely-held business interest. The Ruling, as modified and amplified over the years,[1] states that the following factors should be considered:

**(1) The Nature of the Business.** The appraiser must consider the nature and history of the business. What the business does and how the business makes money are key considerations in the valuation of the business interest. Future performance also has a major impact

on a business's value. Sometimes, a business's past financial performance can be used to predict the business's future performance. An analysis of the gross and net income and dividends over a long period of time can be particularly useful to assess the stability of the business and its probable future financial performance. Events that take place closer to the valuation date are given greater consideration than events that happened further from the valuation date. Nonrecurring events are given significantly less consideration because they have little or no effect on future performance and, therefore, should have little or no effect on value.

**(2) The Economic Outlook in General and the Outlook of the Specific Industry.** The general economic outlook of both the national economy and the economy of the specific industry in which the business operates will impact the valuation of the business interest. This factor includes the success of the business in relation to its competitors in the marketplace. The loss of a "key-person" may have a detrimental effect on the viability of the business and, therefore, also must be considered. If the business has purchased a life insurance policy on the "key-man," the value of the policy must be added to the value of the business interest. See, e.g., *Estate of Mitchell v. Comm'r*, 74 T.C.M. 872 (1997), rev'd on other grounds, 250 F.3d 696 (2001).

**(3) The Book Value of the Stock and Financial Condition of the Business**. A business' historical and current financial condition is of great importance in the determination of value. The IRS typically reviews two or more years' of the business's prior financial statements starting with the year immediately preceding the valuation date. The appraiser should determine from the business's financial statements the (i) liquidity of the business, (ii) gross and net book value of principal classes of fixed assets, (iii) working capital,
(iv) long-term indebtedness, (v) capital structure, and (vi) net worth. The financial statements will determine what the business is worth based solely on its net asset value and will assist the appraiser in assessing the future performance of the business.

**(4) The Earning Capacity of the Business**. The profit-and-loss statements should be reviewed to determine the future earning capacity of the business. The profit-and-loss statements will separate the recurring from the nonrecurring earnings and expenses, and the investment income from the operating income. The profit-and-loss statements also would identify whether any portion of the business is operating at a loss. In attempting to assess how the risk of future profits would affect the business's value, an appraiser should consider the use of raw materials and supplies in the case of manufacturers, processors, and fabricators; the cost of purchased materials for merchandisers; utility services; insurance; taxes; depletion or depreciation; and interest.

After a proper earnings history is compiled, a capitalization rate or factor is applied to each of the years to determine the proper weight to be accorded each year's earnings or losses. There is no generally accepted method for determining the property capitalization rate, however, important factors to consider include the nature of the business, the risk involved and the stability or irregularity of earnings. One approach is to focus on particular earnings trends over the past few years. Clear trends can indicate cyclical business patterns. See, e.g., *Estate of Giselman v. Comm'r*, 57 T.C.M. 391 (1988).

**(5) The Dividend-Paying Capacity**. The business' ability to pay

dividends is a relevant consideration in the valuation of a business interest. The major focus should be on the business' ability to pay, rather than the actual amount of dividends paid in prior years because the actual payment of the dividends is within the absolute discretion of the controlling shareholders.

Typically, courts will apply a capitalization factor to the dividend-paying capacity to generate a fair market value for the stock. The capitalization factor often comes from a review of comparable companies. See, e.g., *Central Trust Co. v. U.S.*, 305 F.2d 393 (Ct. Cl. 1962).

**(6)** **Goodwill and Other Intangible Value**. The value of a business's goodwill or other intangible assets can sometimes be illusive because of the difficulty in quantifying something that physically does not exist. Rev. Rul. 59-60 describes goodwill as the excess of the net earnings over and above the fair return on the net tangible assets. However, goodwill also can be the value of the business' reputation and name. Another view is that goodwill need not be separately valued as it is included in the value of the entity as a whole, the amount in excess of the net book value of the assets. While there are a number of different methods that may be used to value goodwill or other intangible assets, the appraiser should recognize the existence of the intangible asset and give it due consideration in the appraisal.

In many cases, goodwill may not be present, or if present, may not be transferable. For example, if a corporation's goodwill depends primarily on one individual, the goodwill may be lost at the death of that person. Note that in various other valuation methods, the value of goodwill and other intangibles is already taken into account.

**(7)** **Sales of Stock and the Size of the Block of Stock to be Valued**. Actual sales of stock may be determinative of value, provided the sale is an arm's-length transaction. As discussed below, with publicly-traded stock, a discount may be appropriate for the sale of a large block of stock. In contrast, large blocks of stock in a closely-held business, especially where they represent a controlling interest, more commonly increase the value of the stock because of the control premium.

**(8)** **The Market Price of Stock of Comparable Publicly-Traded Businesses**. The market price of publicly-traded stock of comparable businesses also must be considered, pursuant to IRC § 2031(b). The stock must be traded on an active and public market as of the valuation date. Stocks listed on active and public market exchanges are given priority over stocks listed on less active, over-the-counter exchanges. Although the Internal Revenue Code only requires the businesses to be comparable, other relevant factors also must be considered. For example, a business with a shrinking market share and declining profits is not directly comparable, without adjustment, to a business with an expanding market share and growing profits. Comparability can be verified by reviewing the eight factors set forth in Rev. Rul. 59-60 to determine the extent to which each of the corporations is similar with respect to each factor.

Each of the relevant factors should be given a different weight depending on the particular facts and circumstances of each comparable business. For some operations, such as service-oriented businesses, earnings will be the most important factor in the determination of value. For other operations, such as financial institutions, a valuation of the business' capital assets will be the controlling factor.

**b.** **Valuation Methods**. Rev. Rul. 59-60 also provides that an appraiser may elect to use one or more valuation methods to determine the value of a business in addition to the factors listed above. Four of the most common methods are discussed below:

(1) **Earnings Method**. This method determines the fair market value of a business by assuming that an investor would pay for the present value of the business' future earnings potential. The future earnings an investor would expect to receive are calculated over a term of years and then each year's projected earnings are discounted to present value.

A variation of the earnings method is the capitalization of earnings approach. See, e.g., *Estate of Deputy v. Comm'r*, T.C. Memo. 2003-176. This approach analyzes the price-to- earnings ratio of other comparable businesses. Such ratio is then applied to the subject business's earnings and a per share price is determined. Unfortunately, in order for this method to be accurate, it requires a comparison of only truly comparable businesses. Even where two businesses are similar, without certain adjustments to account for their differences, they may not be truly comparable. Thus, this approach can create a flawed valuation if not applied correctly.

> **EXAMPLE:** Company A has a price-to-earnings (PE) ratio of 2.5, Company B has a PE ratio of 3.0, and Company C has a PE ratio of 3.5. The average PE ratio between these three companies is 3.0. The earnings per share of Company D is $50. Applying the average PE ratio of 3.0 to Company D's earnings per share results in a share price of $150 ($50 x 3). However, if Companies A, B, and C are not truly comparable, some modifications to the average PE ratio would be necessary to achieve an accurate result in the valuation of Company D.

**(2)** **Asset Value Method**. This is one of the easiest methods appraisers use to value a business interest, but it can also be one of the least accurate methods. The value of the business is determined by taking the book value of the assets and subtracting liabilities, amortization and depreciation. This method does not attribute any value to the intangible assets of the business and frequently uses the historical or book value of a business' assets instead of the assets' fair market value. While a business's assets may be a factor in its overall value, this method alone rarely captures the whole value of the business.

A variation from this pure asset value method can be used to produce a more accurate appraisal. For example, the ratio of a comparable business' book value to its sales price can be applied to the subject business' book value to arrive at the fair market value. Although this is essentially a comparable sale approach, it uses a variation of the asset value method to determine a value. This method is only valid if there are comparable businesses with provable ratios. Another method assumes that the value of the corporation is based on the fair market value of its underlying assets, rather than their book value.

The Tax Court has agreed with the statement in Rev. Rul. 59-60 that "[t]he value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock." See, e.g., *Estate of Renier v. Comm'r*, T.C. Memo. 2000-298. However, most courts are reluctant to use book value alone

without any modification, such as those discussed above. See, e.g., *Hagen v. Comm'r*, 57 T.C.M. 1489 (1989), *aff'd in part and rev'd in part*, 951 F.2d 1259 (10th Cir. 1991).

**(3) Dividend Method**. This method analyzes the history of a business' dividend-paying capacity to predict future dividends to value the business interest. The rationale of this method is that an investor would pay for the present value of a business' future dividend payments. The concern with this approach is that the actual dividends paid in prior years are often irrelevant because the decision to pay dividends in any given year is entirely within the absolute discretion of the controlling shareholders. In light of such discretion, the appraiser must perform a more subjective determination of the business' capacity to pay dividends, which is a function of earnings, current capital needs, and future capital needs.

As with the capitalization of earnings approach, dividend-paying capacity can be capitalized by using comparable figures from similar businesses. The appraiser's ability to select truly comparable businesses is critical to prevent inaccurate results.

**(4) Market Method**. This method compares the overall value of similar businesses, rather than comparing only the components of similar businesses. See, e.g., *Estate of Leichter v. Comm'r*, T.C. Memo. 2003-66. As with other comparable methods, finding a truly comparable business is crucial. Differences in geographic location, market share, management and structure, industries, positions within a given industry, product lines and competition can cause wide variations in value. Therefore, certain modifications may be required in the valuation of comparable businesses in order to achieve an accurate result.

➔ **Planning Point:** Courts have determined that an in-depth look at all the relevant facts and circumstances should be made before an appropriate value can be determined. See, e.g., *Provitola v. Comm'r*, 60 T.C.M. 939 (1990), *aff'd*, 963 F.2d 385 (11th Cir. 1992); *Estate of Gwinn v. Comm'r*, 25 T.C. 31 (1955). Also, the valuation method chosen may also be significant in determining whether particular types of discounts are available. Consequently, it is extremely important that a skilled and experienced appraiser value the business.

### 3. Valuation of Notes

The value of a promissory note is presumed to equal the unpaid principal balance plus interest accrued as of the valuation date. Treas. Reg. §§ 20.2031-4 and 25.2512-4. If a lower valuation is desired, the taxpayer must prove that the note is not collectable or that the note is worth less than the unpaid principal balance due. If the promissory note is secured, the burden of proof is on the taxpayer to prove that the pledged collateral to secure the note is insufficient to satisfy the obligation.

### 4. Valuation of Cash on Hand or on Deposit

Cash on hand or on deposit is one of the easiest assets to value. The value is equal to the amount included in the decedent's gross estate. Treas. Reg. § 20.2031-5. If there are

outstanding checks on the valuation date that were written for bona fide obligations and they are subsequently honored by the bank, the amount of cash included in the estate may be decreased by the amount of the outstanding checks. Obviously, the reduction is not allowed if the obligation is allowed as a separate deduction from the gross estate.

**5. Household and Personal Effects**

**a. <u>General Rule</u>**. Household and personal effects are valued based on the general rule of a willing buyer and a willing seller. Treas. Reg. § 20.2031-6. The price the grantor paid to purchase an item that was subject to excise tax can be used to prove its value where the purchase was made within a reasonable time before the valuation date. Treas. Reg. § 25.2512-7. In the valuation of personal property, the built-in obligation of any excise, luxury, or other taxes may be taken into account if it would affect the price a willing buyer would pay for that item.

**b. <u>Highly Valuable Personal Property</u>**. For personal property items that are highly valuable or have a unique market, an appraisal of such items often is recommended. If the value of a personal property item exceeds $3,000, an appraisal must be attached to the tax return. Treas. Reg. § 20.2031-6(b). As with the valuation of other property, the appropriate market must be used to determine value. The retail market is usually the relevant market for the valuation of personal property because that is where most people purchase personal property; thus, a car should be valued at its retail price, not its wholesale price. Price guides can be used to prove value, but an appraisal is better evidence of value.

**c. <u>Filing Requirements</u>.** The Regulations suggest preparing and filing with the tax return a room-by-room itemized list of personal effects. Items that do not individually exceed $100 in value can be grouped together on the itemized list. In lieu of the itemized list, the executor can attach to the tax return a written statement containing a declaration made under penalty of perjury setting forth the values determined by a competent appraiser or dealer.

➔ **<u>Planning Point</u>:** Unless there is a significant amount of valuable personal property or unique objects, such as rare musical instruments or works of art, a written statement by the executor setting forth the value of personal property will suffice.

**6. Annuities, Life Estates, Remainders and Other Actuarial Values**

**a. <u>General Rule</u>.** Life interests and interests that vest in the future must be valued as of the valuation date. Since the interest is only for a life or does not become possessory until a future date, the value of that interest must be discounted to its present value. In applying the discount, the IRC § 7520 rate is used to determine the interest's present value for gift and estate tax purposes.

**(1) <u>Calculation of Actuarial Interest</u>**. Generally, the valuation of an annuity, life estate, remainder interest or any other interest based upon the life expectancy of a person is determined by the present value, as of the valuation date, of such interest. The first step in the valuation of an actuarial interest is to determine the applicable IRC § 7520 discount rate.

The IRC § 7520 rate is updated monthly and applies to most actuarial interests regardless of the taxpayer's gender. The IRC § 7520 rate is used for valuations made after April 30, 1989.

**(2)** **Factors and Tables**. The IRC § 7520 rate is used in conjunction with the term of years or measuring life governing the actuarial interest to get the annuity, life estate, or remainder factor from tables published by the IRS. The appropriate factor is then multiplied by the value of the property on the valuation date to determine the present value of the actuarial interest. The tables for determining the present value of actuarial interests are contained in different sections of the Regulations. The present value of an actuarial interest that is valued between April 30, 1989 and May 1, 1999 is determined under Treas. Reg. § 20.2031- 7A(d). For actuarial interests valued after April 30, 1999 the table contained in Treas. Reg. § 20.2031-7(d) is used.

**(3)** **100% Rule**. The value of all the interests in a single property, both lifetime interests and remainder interests, must be equal to 100% of the value of the subject property on the valuation date. Thus, if the lifetime interest is equal to 75% of the property value, the remainder interest must be equal to the remaining 25%.

**(4)** **Exceptions to Use of IRC § 7520 Rate**. The IRC § 7520 rate is not applicable for the valuation of life insurance, endowment, and annuity contracts subject to IRC § 72; deferred compensation under IRC §§ 83, 451, 457, 3121(v), and 3306(r); valuation statements evidencing compliance with qualified plan requirements under § 6058; interest-free and below-market loans under IRC § 7872; or the valuation of nonqualified retained interest under § 2702(a)(2)(A). See Treas. Reg. §§ 1.7520-3(a), 20.7520-3(a), and 25.7520-3(a).

**(5)** **Terminal Illness**. Additionally, if the measuring life is a person who is terminally ill, the IRC § 7520 rate will not apply. The individual's actual life expectancy must be used for the valuation of the actuarial interest. To be terminally ill, the person must have an incurable illness or deteriorating physical condition with at least a 50% probability that the person will die within one year. If the individual lives for 18 months or longer, however, the IRS assumes that the individual was not terminally ill at the valuation date unless proven otherwise by clear and convincing evidence. Treas. Reg. § 1.7520-3(b)(3).

**b.** **Remainder and Reversionary Interests.**

**(1)** **Calculation of Reminder Interests**. The present value of a remainder or reversionary interest is calculated by multiplying the value of the property by the remainder interest actuarial factor found in Table B (for interests taking effect after a term of years) or Table S (for interests taking effect after one measuring life). See Treas. Reg. § 20.2031-7(d)(6) and (d)(7).

The first step is to determine the applicable IRC § 7520 rate. The next step is to obtain the remainder factor from the appropriate table by using the IRC § 7520 rate and the term of years or the age of the measuring life. Note that the correct age of a person is the age as of that person's nearest birthday. Finally, the remainder factor is then multiplied by the value of the property on the valuation date and the product of that calculation is the present value of the remainder or reversionary interest.

**(2)** **Ascertainable Remainder Requirement**. The IRC § 7520 rate will not be used to value a remainder interest if it is subject to excessive contingencies. An unimpeded right to invade trust corpus would render the remainder interest valueless. However, a principal invasion power will not render the remainder interest valueless if it is subject to an ascertainable standard. The Regulations state that the willing buyer/willing seller test must be applied to determine if the remainder interest has any value in light of the corpus invasion power. Treas. Reg. § 20.2031-9.

➔ **Planning Point:** If a grantor gifts a remainder interest in trust, but gives the lifetime beneficiary the right to invade corpus without an ascertainable standard, the remainder interest will not be valued using the IRC § 7520 rate and the value of the life estate will be 100% for gift and estate tax purposes. In order to avoid this potential adverse tax consequence, an ascertainable standard should be used to restrict the invasion power of the lifetime beneficiary so that the remainder interest can be valued using the IRC § 7520 rate and the associated tables.

**c. Term of Years and Life Interests.**

**(1)** **Calculation of Interest**. The same steps described above are used to determine the present value of a life estate or a term of years interest. The life estate factor or term of years factor, as the case may be, is multiplied by the value of the property in order to determine the present value of the life estate or term of years. The life estate and term of years factors can be found in IRS Pub. 1457 by using the appropriate IRC § 7520 rate and the measuring life or term of years. The life estate or term of years factor also can be calculated by subtracting the remainder factor (discussed above) from 1.0. See Treas. Reg. § 20.2031- 7(d)(2)(iii).

An easier way to determine the present value of a life estate or term of years is to subtract the present value of the remainder interest from the value of the property. Since the combination of the life estate and the remainder interest must equal 100% of the value of the property on the valuation date, the calculation of one of the two interests will result in the value of the other.

**EXAMPLE:** X has given B a life estate and A a vested remainder interest in real property. The entire interest in the real property is worth $1,000,000 on the valuation date. A's interest will take effect on the death of the life tenant, B. On the valuation date, B is 46 years old and the IRC § 7520 rate is 6.0%. Under Table S in Treas. Reg. § 20.2031-7(d)(7), the applicable remainder factor is .19725. The present value of the remainder interest is $197,250 ($1,000,000 x .19725). Therefore, the value of the life estate given to B is $802,750 ((1.0 - .19725) x $1,000,000). The life estate also can be valued by simply subtracting $197,250 from the $1,000,000 value of the property since the combination of the life estate and the remainder interest must equal 100% of the value.

**(2)** **Sale of Interests**. If the life tenant and the remainder beneficiary sell the interest and split the proceeds equally, the life tenant will be deemed to have made a gift

to the remainder beneficiary to the extent the life tenant's proceeds from the sale are less than his or her fractional share of the interest, as determined by the Regulations discussed above. Rev. Rul. 79-225.

**(3)** **Terminal Illness**. The IRC § 7520 rate will not be used to value life estates if the life tenant is suffering from a terminal illness. The actual life expectancy of the person with the terminal illness would be used instead.

**(4)** **Unequivocal Right to Income Requirement**. The IRC § 7520 rate will apply only if the income beneficiary of a trust has an unequivocal right to the income. If the beneficiary's income interest can be altered or diverted to the benefit of another without the income beneficiary's consent, the use of the IRC § 7520 rate is precluded.

**d.** **Annuities.**

**(1)** **Calculation of Annuity**. Annuities are valued by multiplying the aggregate annual payments of the annuity by the annuity factor. The IRS sets forth the annuity factors in Publication 1457. The annuity interest also can be determined mathematically by subtracting the applicable remainder factor (contained in Table B or Table S of Treas. Reg. § 20.2031-7(d)(6) and (d)(7)) from 1.0 and then dividing the result by the IRC § 7520 rate.

**(2)** **Adjustment Factor**. If the annuity is payable at the end of semiannual, quarterly, monthly, or weekly periods, an adjustment must be made to the calculation. The adjustment is made by multiplying the adjustment factor found in Table K of Treas. Reg. § 20.2031-7(d)(6) by the present value of the annuity.

> **EXAMPLE:** A is 67 years old and has the right to receive an annuity of $50,000 per year for life, paid quarterly. The IRC § 7520 rate on the valuation date is 6%. Under Table S in Treas. Reg. § 20.2031- 7(d)(6), the applicable remainder factor is .44556. Thus, the annuity factor is 9.2407 ((1.0 - .44556) / .06). Since the annuity payments are paid quarterly, an adjustment factor of 1.0222 from Table K of Treas. Reg. § 20.2031-7(d)(6) must be used. The present value of the annuity is $472,292.18 (($50,000 x 9.2407) x 1.0222).

If the annuity payments are made at the beginning of semiannual, quarterly, monthly, or weekly periods, the adjustment factor is determined using Table J of Treas. Reg. § 20.2031-7(d)(6).

**(3)** **Terminal Illness**. As with life estate and remainder interests, the annuity tables are not used if the annuitant is terminally ill and death is imminent. In such a case, the actual life expectancy of the annuitant with the terminal illness is used to value the annuity interest.

## E. Valuation of Real Estate

### 1. General Rule

Real property is valued using the general willing buyer/willing seller rule. In addition, vacant land is valued based on its "highest and best use." This means that if the decedent owned a vacant lot in the middle of a housing tract, the land would not be valued merely as barren land. The vacant lot would be valued as property that could be developed, subject to certain zoning restrictions.

Valuation of real property for transfer tax purposes always should be done by a competent appraiser.

**2. Commercial Real Estate**

**a. <u>Income Method</u>**. Commercial real estate often is valued based on the stream of income it derives. The valuation of apartments, office buildings and other commercial facilities often depends on a capitalization of income approach. Of course, the capitalized income must be adjusted to take into account costs associated with the real property. For example, a property that requires updating or extensive repairs would be less valuable than a new property or a newly remodeled property.

**b. <u>Comparable Sales Method</u>**. A comparable sales approach also can be used to value commercial real estate. This approach requires finding sales of similar properties and then adjusting the value of the subject property for any differences.

**c. <u>Factors Affecting Value</u>**. Whether an appraiser uses a capitalization of income approach, a comparable sales approach, or some other approach, there are a number of different factors that will affect value. These factors include:

- location of the property,
- zoning and local regulations,
- the proximity to transportation,availability of parking, and
- any negative factors associated with a nearby nuisance (such as loud noises close to a hotel).

As with most real property, location is usually the paramount factor for valuation purposes. Commercial property will be valued based on its proximity to a desired location for a particular type of use. For office buildings, it may be proximity to transportation and business centers. For retail shopping centers, the proximity to major thoroughfares will weigh heavily on value. For apartment buildings, locations away from commercial centers tend to be more valuable.

➔ **<u>Planning Point</u>:** By carefully scrutinizing the various factors that may affect the property's value, an appraisal can be increased or decreased, based upon a variety of relevant factors. Because the appraisal of real estate can be somewhat subjective, working closely with an appraiser may result in achieving the desired planning goal.

The aggregation of multiple buildings may also increase the value of the real property. For example, shopping centers are usually more valuable when considered as one property instead of

a group of individual stores.

**d. Large Hotels and Commercial Complexes**. Large hotels and commercial complexes often are valued as businesses rather than as real estate. The value of these types of properties usually is more than the value of the underlying land and building. Large hotels and commercial complexes carry on various activities that are closely associated with a business, such as operating spas and providing convention or office services. Therefore, the valuation of this type of property is more closely akin to a business valuation rather than a valuation of only the land and building. A valuation of the entire endeavor requires, among other things, the inclusion of the income from all the various sources within the property and the deduction of the corresponding operating expenses.

**3. Residential Real Estate**

**a. Comparable Sales Method**. Residential real estate primarily is valued by using a comparable sales approach. Residential property usually does not produce income, except for multi-unit dwellings. It is important that an appraiser analyze a number of comparable sales so that the subject property can be properly valued. Once the comparable sales have been compiled, certain adjustments can be made to account for differences between the comparable sales and the subject property. Since no two pieces of real property are ever identical, failure to adjust for differences between properties may result in an inaccurate appraisal. Unfortunately, the types and amounts of each adjustment often are subjective.

**b. Time and Terms of Comparable Sales**. Comparable sales near the valuation date are probative of value. If there is a passage of time between the comparable sale and the valuation date, adjustments must be made to the valuation to account for the effect of the passage of time. Additionally, if the comparable sale had unique circumstances surrounding the sale (*e.g.*, the comparable sale was a forced sale, the terms of the sale were more favorable than normal, or if the comparable sale was a part-gift, part-sale transaction), then adjustments would be required to account for the unique circumstances in order for the sale to be considered a comparable sale.

**c. Geographic Proximity of Comparable Sales**. Comparable sales need to be in the same general geographic area as the subject property. If the comparable sale is located in a less desirable neighborhood, the value must be adjusted to account for the difference. A difference in the physical location of the comparable sale to the subject property also can affect value. For example, a property that is close to a busy street would be less valuable than a property on a cul-de-sac. Also, a property with a panoramic view is more valuable than a property with no view. Finally, the lot sizes and land use restrictions will affect the value. All of these various factors must be taken into account and properly adjusted to arrive at the fair market value of the subject property.

➔ **Planning Point:** Working closely with a competent appraiser can be the difference in achieving your planning objectives. Focusing on the differences between the comparable sales and the subject property can help justify an increase or decrease in value, depending on the desired result. Carefully analyzing the comparable sales with the appraiser can lead to a beneficial result.

**4. Vacant Land**

**a. <u>Highest and Best Use</u>**. Vacant land is to be valued at its "highest and best" use. This would be the use that will produce the highest value for the property. The use also must be one that is reasonable within the geographic area. Vacant land that is surrounded by farmland should not be valued as a possible residential development property. However, if there is a residential development in the surrounding area, it may be reasonable to value the vacant land as such.

**b. <u>Factors Affecting Value</u>**. Comparable sales are primarily used to value vacant land, much like the valuation of residential real estate. In order for a comparable sale to be meaningful, it must be similar enough to the subject property and close enough in time to the valuation date. The IRS, in Rev. Proc. 79-24, sets forth the following factors for comparing similar pieces of vacant land:

- location
- configuration of property
- zoning
- accessibility
- water rights
- easements
- soil condition
- vegetation cover
- mineral rights
- riparian rights

**5. Leases and Options**

**a. <u>Leases.</u>**

**(1) <u>Lessor's Interest</u>**. An interest in a lease can be either an asset or a liability. The effect of the lease on the value of the property depends on an analysis of comparable leases. If a lease on the property has more favorable terms for the lessor than comparable leases, the property can be worth more. Conversely, if a lease has less favorable terms for the lessor, the property can be worth less.

**(2) <u>Lessee's Interest</u>**. A lessee's interest in a lease also can be considered an asset or a liability. If the lease is a long-term lease with terms favorable to the lessee, the lessee has a valuable interest. A lease also can be valuable if the lessee has a below- market lease with the right to sublease the property for a profit. In this case, the value of the lease would be the present value of the future net income from the sublease. On the other hand, if the lease is a long-term lease with less favorable terms for the lessee, the lessee has a potential liability if the interest were to be sold.

**b. <u>Options</u>**. The IRS has stated in Rev. Rul. 80-186 that the value of an option to purchase real property depends on various factors including (i) the fair market value of the land on the date the option was given, (ii) the option price, (iii) any potential for appreciation or

depreciation during the period, and (iv) the time period during which the option may be exercised.

The likelihood that the option will be exercised also affects its value. If the option price is unreasonably high, the likelihood of the option holder exercising the option decreases and so does the value of the option. Conversely, if the option price is low, the likelihood of the option holder exercising the option increases and so does the value of the option. All of these factors must be considered in determining what a willing buyer would pay to a willing seller for the option.

**6. Fractional Interest Discounts**

**a. General Description**. The value of a fractional interest in any property is usually not equal to a proportionate share of the value of the entire property because the ownership of a partial interest is less desirable than ownership of the entire interest. The owner of a partial interest of property cannot freely or unilaterally make decisions on issues concerning the property. Co-owners of property are forced to (i) deal with each other, (ii) consider the rights of the other co-owners, and (iii) make joint decisions on issues regarding the property. If a dispute arises between co-owners, the value of their fractional interests in the property could be compromised.

With respect to the ownership of real property, fractional interests are less desirable because co-tenants of real property have the right to occupy the entire property, provided it does not conflict with the use by the other co-tenants. Also, if an irreconcilable dispute arises between co-tenants, the property must be physically partitioned or sold.

> **EXAMPLE:** X owns a 10% interest in real property. The property is valued at $1,000,000. X's proportionate share of that value is $100,000. If X sold his 10% interest in the property, he would probably receive less than $100,000 because the sale of a fraction of the interest is less desirable to buyers than a sale of the whole interest.

**b. The IRS's Position on Fractional Interest Discounts**. Even though the IRC and Regulations do not provide any guidance on the validity or the amount of a fractional interest discount, the IRS has a strong bias against the use of fractional interest discounts. The IRS will generally disallow the fractional interest discount altogether or limit its value to the cost of partition.

The IRS's position that a fractional interest discount should be limited to the cost of partitioning the property is based partly on *Estate of Whitehead v. Comm'r*, T.C. Memo 1974-53. In *Whitehead*, the Tax Court allowed a fractional interest discount where the taxpayer was able to substantiate the value of the discount by providing evidence of the legal fees and surveying costs for partitioning the property. The taxpayer also proved that the fractional interest depressed the value of the entire property in the relevant marketplace.

The Court's rationale in *Whitehead* lead the IRS to hold in TAM 9336002 that a fractional interest discount is limited to partition costs. The IRS, in TAM 199943003, provides a method to determine the size of the fractional interest discount. Using this method, the IRS determines the proportionate value of the fractional interest and then subtracts the cost of partition allocable to the fractional interest.

TAM 9336002 was subsequently attacked by the Tax Court in *Shepherd v. Comm'r*, 115 T.C. 376 (2000). In *Shepherd*, the court held that the valuation of a fractional interest discount limited to only the partition costs failed to account for other factors that affect value, such as lack of control.

**c.** **Case Law Development of Fractional Interest Discounts**. The origin of fractional interest discounts is in case law. The courts tend to focus on the facts and circumstances surrounding the real property to determine if a fractional interest discount is appropriate.

**(1)** **Cases Upholding Fractional Interest Discounts**. The first case to hold in favor of a fractional interest discount was *In re Gilberts Estate*, 163 N.Y.S. 974 (1917). In *Gilberts*, the court allowed a 15% discount for a one-third fractional interest in property. Other courts following *Gilberts* have allowed fractional interest discounts:

- The court in *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982), held that a fractional interest discount is appropriate for a one-half interest in real estate held as community property. In *Propstra*, the court reasoned that each spouse's interest should be valued separately because the family attribution rules do not apply in this context and that a fractional interest discount would apply to each of the spouse's interest.
- In *Estate of Bonner v. U.S.*, 84 F.3d 196 (5th Cir. 1996), the court held that a fractional interest discount was appropriate on the death of the surviving spouse where a QTIP trust owned an undivided one-half interest in property and the surviving spouse owned the other one-half interest. The court reasoned that even though the entire interest in the property is included in the surviving spouse's estate for estate tax reporting purposes, the surviving spouse has no control over the distribution of the property in the QTIP trust. Therefore, the two interests should be valued separately. See, also, *Estate of Mellinger v. Comm'r*, 112 T.C. 26 (1999), *acq*. AOD 99-006, 1999-35 I.R.B. 314;
  *Estate of Nowell v. Comm'r*, T.C. Memo. 1999-15; *Estate of Lopes v. Comm'r*, T.C. Memo. 1999-225.

**(2)** **Cases Disallowing the Fractional Interest Discount**. Courts have also disallowed the use of fractional interest discounts where there was limited evidence to support its use. The following cases illustrate a few of the circumstances where the discount was not allowed:

- In *Claflin v. Comm'r*, 2 B.T.A. 126 (1925), the decedent owned a nine-fourteenths interest in a Massachusetts trust and the trust owned three buildings. The estate's expert argued that the decedent's fractional share should be discounted by 25% because it was worth less than his proportionate share of the whole. The Court rejected the discount, holding that there were no "special conditions" that would reduce the value of the fractional share.
- In *Estate of Barclay v. Comm'r*, 2 B.T.A. 696 (1925), an estate attempted

to get a 10% fractional interest discount based on the testimony of an expert who claimed that fractional interests were routinely discounted in the local real estate market. The court disallowed the discount because the IRS had evidence that actual sales of the fractional interest were routinely sold for more than their proportionate share of the entire value of the property.

- In *Estate of Young v. Comm'r*, 110 T.C. 297 (1998), the decedent owned property with his wife in joint tenancy with right of survivorship. The court held that a fractional interest discount was not appropriate because IRC § 2040(a) requires that joint tenancy property be included in the decedent's estate at 100% of its fair market value, less any contribution made by the surviving spouse. The fractional interest discount was not allowed because 100% of the value of the joint tenancy property was included in the decedent's estate. Furthermore, the joint tenancy property became the sole interest of the spouse after the decedent's death so there was no reason to discount the property.

➔ **Planning Point:** The IRS has aggressively sought to eliminate the use of fractional interest discounts. The courts, on the other hand, have allowed fractional interest discounts where there is evidence to support that a willing buyer would actually discount the price he would pay for the property because of the fractional interest. Anytime a taxpayer owns a fractional interest in real property, the use of a fractional interest discount should be considered.

**7. Special Use Valuation**

**a. General Rule.**

**(1) Highest and Best Use Exception**. IRC § 2032A allows an executor to value certain special use real property for estate tax purposes at a lower amount than the real property's fair market value. If certain requirements are satisfied, the executor may elect to value the real property using the special rules. The special use valuation rules allow the real property to be valued based on its given use instead of the "highest and best use" on the valuation date. Unfortunately, the special use valuation is not available for gifts. For GST tax purposes, the special use valuation is available only for direct skips at death (since the value of the generation-skipping transfer is the same as its estate tax value). IRC § 2624(b).

**(2) Special Use Valuation Limit**. The election can be made only to value real property used for farming or for a closely-held business. Since the property can be valued based on its given use instead of its "highest and best" use, a significant estate tax savings can be achieved. IRC § 2032A, however, can only be used to reduce the fair market value by $1,000,000 (for decedents dying in 2010).

➔ **Planning Point:** The special use valuation rule applies to the value of the entire real property. In community property states, the $940,000 reduction

is against the entire community property interest instead of the decedent's one-half community property interest, except to the extent the surviving spouse contributed to the purchase of the property from his or her separate property.

b. **Requirements for Election of Special Use Valuation.**

(1) **Qualified Real Property.** Only "qualified real property" can obtain a special use valuation. IRC § 2032A defines "qualified real property" as property located in the U.S. that was acquired from or passed from the decedent to a qualified heir and was used for a qualified use by the decedent or his family on the decedent's date of death. Additionally, the decedent or a member of his family must have materially participated in the operation of the business for a total of five years out of the eight years preceding the decedent's death and the value of the property in the decedent's estate must meet certain percentage requirements. The date of the decedent's retirement from the business can be used for the eight- year look-back period rather than the date of death. IRC § 2032A(b)(4).

(2) **Qualified Use.** A "qualified use" is using the property as a farm for farming purposes or using the property in a trade or business other than the trade or business of farming. IRC § 2032A(b)(2).

(3) **Qualified Heir.** A "qualified heir" is a member of the decedent's family who acquires the property from the decedent. A qualified heir can subsequently dispose of the property to a member of his or her own family and the family member who receives the interest will be deemed the qualified heir with respect to the property transferred. A member of the decedent's family is defined to include (i) an ancestor of the decedent, (ii) the spouse of the decedent, (iii) a lineal descendent of the decedent, the decedent's spouse, or the decedent's parents, or (iv) the spouse of any lineal descendent described above. IRC § 2032A(c)(7)(C).

(4) **Percentage Tests.** There are two percentage tests that must be met in order to elect the special use valuation, a 50% test and a 25% test. Under IRC § 2032A(b)(1)(A), the adjusted value of all property, both real and personal, acquired from the decedent by a qualified heir and put to a qualified use must equal at least 50% of the decedent's gross estate. Under IRC § 2032A(b)(1)(B), the adjusted value of the real property acquired from the decedent by a qualified heir and put to a qualified use must equal at least 25% of the adjusted gross estate.

➔ **Planning Point:** It is essential that the qualified heirs receive sufficient assets to meet the rigid percentage requirements. If a portion of the property is distributed to an heir who is not qualified (*i.e.*, a non-family member), the special use valuation may not be available. This does not mean that there must be only one qualified heir. The number of heirs is not important as long as 50% or more of the qualified property is transferred to qualified heirs. The property can pass to more than one qualified heir and still meet the special use valuation requirements.

c. **Determining Value.** Farm property can be valued by the capitalization of

rents method contained in IRC § 2032A(e)(7) or under a multifactor method in IRC § 2032A(e)(8). Closely-held business interests can be valued only by using the multifactor method.

**(1) <u>Capitalization of Rents Method</u>.** Under the capitalization of rents method, fair market value is determined by calculating the present value of the future cash flow. Such method analyzes the rental income of the property for the five years preceding the decedent's death. The average annual gross cash rental income of comparable farmland located in the same geographic area as the subject farmland is determined and then state and local real estate taxes are subtracted. The net income amount is then divided by the average annual effective interest rate for all new Federal Land Bank loans. IRC § 2032A(e)(7)(A). The term "gross cash rental" refers to the total amount of rents received during the year in question for the use of actual comparable farmland. Treas. Reg. § 20.2032A-4(b). The Regulations provide that comparable farmland is farmland in the same locality that meets generally accepted valuation rules for real property. Thus, as with the comparable sales approach, similar properties must be evaluated and the valuation must be adjusted to account for differences between the subject farmland and the comparable farmland, if necessary.

The factors that should be considered in the valuation of comparable farm properties include: (a) similarity of soil determined by objective means; (b) the type of crops grown and their effect on the soil; (c) soil conservation techniques; (d) flooding; (e) slope of the land; (f) capacity for livestock operations; (g) similarity of timber for timberlands; (h) whether property is segmented or unified; (i) number and types of buildings; and (j) proximity of transportation facilities.

**(2) <u>Multifactor Method</u>.** Closely-held business interests can be valued only by using the multifactor method. Farmland also can be valued by this method. In using the multifactor method, five factors should be considered:

- capitalization of income that the property can be expected to yield for business or farm use over a reasonable period of time under prudent management;
- capitalization of the fair rental value of the land for farm or business purposes;
- Assessed land values in a state that provides a differential or use value assessment law for farmland or businesses;
- Comparable sales of other farms or business land in the same geographic area far enough removed from the metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price; and
- Any other factor that fairly values the farm or business land value.

An appraiser must use all of the factors listed above that are relevant to the appraisal of the subject property. The appraiser is prohibited from selecting only those factors that are favorable to the planning goal. The appraiser, however, has the discretion to use different weightings for each factor in the appraisal. While the factors closely resemble normal appraisal methods, there is no requirement that the property be valued at its "highest and best" use. Thus, even though the criteria are subjective, the real property can be valued at a lower amount than it would otherwise

be valued if the "highest and best" use test were used.

**d.** **Appraisal Requirement.** A written appraisal of the subject property must be obtained and attached to the estate tax return. Failure to do so would prevent the property from being valued at its special use. Treas. Reg. § 20.2032A-8(a)(3). If the executor makes a timely election and substantially complies with the Regulations, but files an incomplete appraisal, the executor would be allowed to provide the IRS with the omitted information within a reasonable period of time. IRC § 2032A(d)(3).

### F. Business Interests Discounts

Business interests may be discounted if there are restrictions on ownership. Essentially, discounts are used because the value of a closely-held business as a whole is not equal to the sum of its parts. Thus, a ten percent ownership interest in a business is not necessarily worth ten percent of the entire value of the business. The minority interest may be worth less than ten percent because there is no control over the management of the business or because there is no readily available market to liquidate the interest.

In arriving at the appropriate discounts applicable to the interest being appraised, most appraisers compare the subject interest to other comparable publicly traded interests such as closed end equity mutual funds and studies of the sale of restricted securities. One example is the Institutional Investor Study conducted by the Securities Exchange Commission regarding sales of stock subject to Rule 144. Appraisers will also look at the governing instrument and the governing state law. The nature of the entity's assets are also important. A partnership owning real property will have a higher range of discounts than a partnership owning marketable securities. Return expectations and the level of risk at the entity level, as well as withdrawal and distribution rights are also important considerations.

The appropriateness of a discount or premium will always depend on whether the discount has already been accounted for in arriving at the base value of the business. For example, a minority discount would be inappropriate when the per share price for a minority position in a closely held company is determined based on comparable publicly traded stocks. Similarly, a discount for the loss of a key employee might be appropriate where the underlying valuation has not already accounted for such loss by utilizing reduced future earnings projections.

The most common discounts for business interests are: minority interest discount, lack of marketability discount, and discount for built-in capital gains.

#### 1. Minority Interest Discounts

**a.** **Justification for Minority Discounts.** The holder of a minority interest in a business, whether as a minority shareholder in a corporation or a limited partner in a limited partnership, lacks the ability to control the business. Since a prospective purchaser of a minority interest could not unilaterally make management decisions or control the distribution of dividends, the purchaser of the minority interest would naturally seek to pay a discounted value for such interest.

**EXAMPLE:** A owns 100% of a closely-held corporation. A gives 25%

interests in the corporation to each of A's four children. Each gift will be valued separately and a minority interest discount can be taken for each child's 25% interest. The ownership interest of each child will not be attributed to the others based on their familial relationship. Rev. Rul. 93-12, 1993-1 C.B. 202. Note that the opportunity to obtain a minority interest discount is lost if the entire 100% interest is included in A's estate at his death.

Even though a particular minority business interest lacks control, both the IRS and the Tax Court have stated that no minority discount is available if the purpose of the transaction creating the minority interest is solely to avoid tax. In *Estate of Murphy v. Comm'r*, T.C. Memo. 1990-472, the Tax Court denied minority interest discounts for both gift and estate tax purposes where, 18 days before the decedent's death, the taxpayer made gifts designed to reduce her interest in a corporation from 51.41% to 49.65%, on the grounds that the transfers were made purely for tax avoidance. But see *Estate of Frank v. Comm'r*, T.C. Memo. 1995-132 (court declined to apply substance over form doctrine to disregard the form of transfers).

**b. Swing Vote Premium**. In Rev. Rul. 93-12, 1993-1 C.B. 202, the IRS stated that each individual's equity interest in a business is to be valued separately and there is no attribution of ownership among family members. However, the IRS has asserted that a premium should be added to the value of a minority interest in a business if that minority interest can be combined with another interest to gain control of the business. If each of two individuals has a 45% interest in a business and the interest being valued is the remaining 10%, the IRS may argue that the 10% interest has an additional value, above and beyond its minority interest value, as a "swing vote" because it can be combined with one of the other two interests to gain control of the business. See, e.g., TAM 9436005; *Estate of True v. Comm'r*, T.C. Memo. 2001-167 (rejecting IRS position that a decedent's 38.47% interest in a general partnership was not entitled to a minority interest discount because it was the largest single block of voting rights in the partnership and could be combined with another block to control the partnership), *aff'd*, 390 F.3d 1210 (10th Cir. 2004).

The Tax Court, in *Estate of Magnin v. Comm'r*, T.C. Memo 2001-31, held that the IRS' swing vote theory works only where a minority interest owner has definite ability to gain control of the business. It must be likely that a hypothetical willing buyer can gain control of the business by combining with another shareholder. The hypothetical buyer must be considered without reference to the actual position of the minority interest holder. Therefore, if the minority interest holder has a definite ability in a unique position to combine his interest and take control of the business, that position must be ignored for valuation purposes.

**EXAMPLE:** Father owns a 35% interest in X Co. Father's Son owns a 16% interest in X Co. The remaining 49% of X Co. is owned by one hundred different individual investors with no one investor owning more than 1%. Even though Son could combine his shares with Father to gain control of the business, a hypothetical buyer, one not in the same position as Son, could not be assumed to have the same ability to gain control of the business. Therefore, a swing vote premium is not

appropriate. The hypothetical buyer rule is an objective standard that does not take into account the special relationship of Son and Father. A hypothetical willing buyer probably would not have the same relationship and, therefore, would not pay a premium for the minority interest.

c. **Aggregation of Separate Interests Held by the Same Person**. The IRS has attempted to aggregate blocks of a particular business interest owned by the same person, but in different capacities, such as stock held in a trust for the taxpayer's benefit and stock held outright. Rev. Rul. 79-7, 1979-1 C.B. 294. The courts, however, have been less prone to aggregate such interests. Both the Fifth Circuit and the Tax Court have ruled that a beneficiary's interest in real estate held in a QTIP trust cannot be aggregated with other directly-held real estate interests in the same property for purposes of determining whether a controlling interest exists. *Estate of Bonnor v. U.S.*, 84 F.3d 196 (5th Cir. 1996); *Estate of Lopes*, T.C. Memo. 1999- 225; see also *Estate of Bailey v. Comm'r*, T.C. Memo. 2002-152 (involving stock interests); *Estate of Nowell v. Comm'r*, T.C. Memo. 1999-15 (involving limited partnership interests). The IRS has acquiesced in the Tax Court's position. AOD 1999-0006. However, the Tax Court has aggregated stock held by the decedent outright and stock over which the decedent held a power of appointment. *Estate of Fontana v. Comm'r*, 188 T.C. 318 (2002).

d. **Size of Minority Interest Discounts**. The amount of the minority interest discount varies. The IRS and the courts typically allow up to a 30% minority interest discount. Other special circumstances may justify a discount that is higher than 30%.

➔ **Planning Point:** A minority interest discount should be taken whenever a block of stock lacks control over a closely-held business. However, the amount of the minority interest discount should be carefully considered. While a sizable discount (e.g., over 30%) may be appropriate, an overly aggressive discount may end up costing the client more than the financial benefit derived from the discount itself. A balance should be sought between the tax potentially to be saved as a result of the claimed discount and the time, cost and risk associated with defending the discount.

e. **The IRS' Use of Minority Interest Discounts**. Minority interest discounts can be used by the IRS to the taxpayer's disadvantage. For example, the value of a gift of a minority interest in a business to charity should be reduced to reflect the minority interest discount. If the use of the minority interest discount against the taxpayer is overlooked, it can result in significant adverse tax consequences.

**2. Lack of Marketability Discounts**

a. **Justification for Lack of Marketability Discounts**. The lack of marketability discount is a separate and distinct concept from a minority interest discount. While the two discounts may be somewhat related and often are used to discount the same interest, lack of marketability focuses on the ability of the investor to liquidate the interest. Therefore, it can apply to both a minority and a majority interest in a closely-held business, provided there is no readily available public market for the business interest. *Winkler v. Comm'r*, T.C. Memo. 1989-

231. Of course, a controlling interest is more desirable and, therefore, may be easier to liquidate, but that consideration is merely a factor in determining the size of the lack of marketability discount, not the availability of the discount.

**b. Size of Lack of Marketability Discounts**. The size of the lack of marketability discount depends on the facts and circumstances of the business. Even though some appraisers have taken lack of marketability discounts of up to 70%, the courts tend to limit the lack of marketability discount to approximately 30%. See, e.g., *Mandelbaum v. Comm'r*, T.C. Memo. 1995-255. Assuming both discounts (minority interest and lack of marketability) are applicable, one aggregate discount percentage is often calculated to reflect both discounts.

**c. Factors Affecting Size of Discount**. The lack of a public market is not the only factor that makes an interest unmarketable. Restrictions on the sale of the interest, such as options or buy-sell agreements, may justify a lack of marketability discount. However, not every option contract will reduce the value of the business interest. Treas. Reg. § 20.2031-2(h) states that an option contract held by a decedent that would allow him to dispose of the underlying securities at any price he chooses during his life will be given little weight. Buy-sell agreements and similar arrangements may give rise to a lack of marketability discount, assuming they do not run afoul of IRC § 2703, discussed below, which nullifies the effect such agreements have on the valuation of a business interest in certain circumstances.

Other restrictions on selling the interest can also give rise to a lack of marketability discount. Closely-held stock that cannot be sold for a certain period of time, because of agreements among the owners or because of securities laws, can result in substantial discounts. See, e.g., *Okerlund v. U.S.*, 53 Fed. Cl. 341 (2002), *aff'd*, 365 F.3d 1044 (Fed. Cir. 2004). The cost of potential litigation may also be relevant in determining this discount. *Estate of Newhouse v. Comm'r*, 94 T.C. 193 (1990).

**3. Discount for Built-In Capital Gains**

A discount may be appropriate where an entity, such as a corporation or a partnership, holds an asset with a built-in capital gain. The IRS has suggested that the discount can be taken as a decrease in the entity's income stream or as a liability of the entity. IRS Guide for Income, Estate and Gift Taxes (May 1997).

Courts also have been willing to allow for these built-in capital gain discounts. See, e.g., *Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998). Still, however, the application and size of this discount will depend on the facts and circumstances. The size of the discount is largely determined by the likelihood of the recognition of the capital gain. The appraiser must discern the weight a willing buyer would place on purchasing the business interest with such a tax liability. For example, in situations where it is unlikely that a corporation would be liquidated and no disposition of the business' assets is expected to occur in the near future, the present value of the potential tax liability at a far off future date may be nominal. See, e.g., *Estate of Gray v. Comm'r*, T.C. Memo. 1997-67. If liquidation is likely, however, a discount for the tax liability flowing from such liquidation should be taken into account. See, e.g., *Estate of Davis v. Comm'r*, 110 T.C. 530 (1998).

The Fifth Circuit has stated that the weight to be given to such potential taxes should be the affect such potential taxes would have on a willing buyer. This same court added that when determining the asset-based value of a family-operated, closely-held corporation, there should be a dollar-for-dollar discount for the tax liability. However, the tax liability would not be considered in determining the earnings-based value of the business because this valuation assumes that there will be no sale of the assets. *Estate of Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002). The dollar-for-dollar discount was rejected in *Davis* because there was no planned liquidation or asset sale as of the valuation date. When the Eleventh Circuit was faced with this issue, however, it followed *Dunn* instead of *Davis*, even though there was no planned liquidation. *Estate of Jelke v. Comm'r*, 507 F.3d 1317 (11th Cir. 2007).

**4. Blockage Discount**

Large blocks of publicly-traded stock are difficult to sell in the public marketplace without depressing the price of the stock. Since it is difficult to liquidate a large block of stock without lowering the per share price, the application of a valuation discount is appropriate. Treas. Reg. § 20.2031-2(e). The discount for the sale of large blocks of stock mainly is used for publicly-traded stock. The burden of proof is on the taxpayer to demonstrate that the sale of a large block of stock would depress the price per share in the open marketplace. A large block of stock generally is considered to be an amount of stock that exceeds the volume of shares traded in an average trading day.

The amount of the discount will depend on the effect the sale of the entire block would have on the market price of the stock. A block of stock that substantially exceeds the average daily trading volume of the stock will receive a higher discount than a block of stock that is about equal to the average daily volume. The objective is to arrive at a value that would represent the sales price for the shares had the entire block been liquidated on the valuation date.

Courts have expanded the concept of blockage discounts to such items as real estate and works of art. See, e.g., *Rimmer v. Comm'r*, T.C. Memo. 1995-215; *Estate of Auker v. Comm'r*, T.C. Memo. 1998-185.

**5. Valuation Discounts for Closely-Held Businesses After *Hackl***

*Hackl v. Comm'r*, 335 F.3d 664 (7th Cir. 2003), illustrates how structuring an operating or partnership agreement to restrict severely the rights of the holders of the business interests so as to obtain higher discounts such as the discounts discussed above may cause the donor of such interests to forfeit the ability to make annual exclusion gifts of such interests. The Seventh Circuit in *Hackl* upheld the Tax Court's decision that transfers of LLC interests did not qualify for the annual gift tax exclusion under Section 2503(b)(1). In reaching this conclusion, the court pointed to the LLC's operating agreement, which foreclosed an interest holder's ability to realize any substantial present economic benefit. As a result of this decision, practitioners advising clients who wish to make annual exclusion gifts of business interests should be sure that the operating agreement of the business does not prevent the donees from obtaining immediate use, possession or enjoyment of the gifted business interests. An interest holder's inability, under the entity agreement, to: (a) unilaterally withdraw his or her capital account; (b) independently effectuate a dissolution of the business; and (c) sell his or her business interest without the business manager's

consent in the manager's sole discretion could prevent the gifted business interests from qualifying for the gift tax annual exclusion.

This result might be avoided by giving a donee the unilateral right to sell his or her entire interest to third parties, subject to a right of first refusal by the entity and/or other interest holders to purchase the interest at the same price and terms as contained in a bona fide offer from a third party. In addition, perhaps the business manager's discretion to retain funds should be limited to amounts commensurate with the needs of the business with the balance of the funds being distributable to the interest holders. Alternatively, the business agreement could include a provision giving each donee the right to withdraw assets from the entity whenever gifts of entity interest are made, similar to a *Crummey* withdrawal right. The right can be limited to the fair market value of the gifted interests and only be available for a limited period of time. Such a provision should bar any argument that the donee does not have the right to the immediate use, possession and enjoyment of the property in the economic sense.

### G. Chapter 14 Valuation Rules Regarding Certain Rights and Restrictions

#### 1. Buy-Sell Agreements and Other Sale Restrictions: IRC § 2703 and Treas. Reg. § 20.2031-2(h)

**a.** **Definition of a Buy-Sell Agreement**. Generally, a buy-sell agreement is an agreement among the owners of an entity and the entity itself to purchase and sell interests in the entity at a price set under the agreement upon the occurrence of a specified triggering event (e.g., death, disability, an offer to purchase an owner's interest from an outside party, or termination of employment). One of the primary benefits of a well drafted buy-sell agreement is that it may establish the value of a deceased owner's interest for estate tax purposes if the agreement satisfies the requirements discussed below. It is crucial to the effectiveness of any buy- sell agreement to ensure that the provisions of IRC § 2703 and Treas. Reg. § 20.2031-2(h) are satisfied so that the buy-out value established in the buy-sell agreement is accepted for federal transfer tax purposes.

**b.** **Treas. Reg. § 20.2031-2(h)**. In general, the value of a decedent's business interest established under a buy-sell agreement or similar arrangement is disregarded for estate tax purposes, and the estate tax value of such interest is the fair market value of such interest at the decedent's date of death. However, with regard to buy-sell agreements and similar arrangements created before October 8, 1990 and not substantially modified (defined below) after that date, Treas. Reg. § 20.2031-2(h) provides an exception to this general rule for property that is subject to a valid buy-sell agreement or similar arrangement. For this exception to apply and for the agreement or arrangement to establish the value, for estate tax purposes, of the property subject to the agreement or arrangement, the agreement or arrangement must meet the following requirements:

- The price must be fixed and determinable under the agreement or arrangement,
- The agreement or arrangement must be binding upon the decedent during his or her lifetime,
- The agreement or arrangement must represent a "bona fide business arrangement" and
- The agreement or arrangement must not be a device to pass the interest to the

natural object of the decedent's bounty for less than adequate and full pecuniary consideration.

In addition to the requirements under IRC § 2703 and its accompanying regulations (discussed below), the above requirements also apply to agreements and arrangements created after October 8, 1990 and to those agreements and arrangements created before that date and substantially modified after that date. The last two requirements listed above, however, were codified in IRC § 2703. Thus, for agreements and arrangements created after October 8, 1990 or substantially modified after that date, only the first two requirements listed above constitute additional requirements separate from IRC § 2703 that these agreements and arrangements must meet. See, e.g., *Estate of Blount v. Comm'r*, 428 F.3d 1338 (11th Cir. 2005).

**c.** **IRC § 2703**. IRC § 2703 was enacted to stop perceived abuses in the valuation of business interests, especially in the closely-held business setting, facilitated by using a buy-sell agreement or similar arrangement to place restrictions on the disposition of a business interest. The objective of IRC § 2703 is to nullify the effect such restrictions have, for transfer tax purposes, on the valuation of a business interest unless the agreement or arrangement is truly bona fide and arm's-length. In the typical case, IRC § 2703 causes buy-sell agreements to be disregarded for estate tax purposes where an artificially low buy-out price is set that results in the business or remaining interest holders purchasing the subject interest for less than fair market value. In the absence of IRC § 2703, and assuming other pre-IRC § 2703 requirements were met, the price paid for the subject interest would establish the value of the parent's stock for federal estate tax purposes (even though the stock may actually be worth significantly more). See Treas. Reg. § 20.2031-2(h); *St. Louis County Bank v. United States*, 674 F.2d 1207 (8th Cir. 1982).

Under IRC § 2703(a), such restrictions are disregarded for estate, gift and GST tax purposes if the agreement or arrangement is entered into after October 8, 1990 and obligates the owner to sell the business interest for less than fair market value. The rules of IRC § 2703(a) apply to any restrictions on disposition of a business interest contained in any corporate, partnership or LLC agreement, corporate bylaws, articles of incorporation or capital structure of any entity. Treas. Reg. § 25.2703-1(a)(3). IRC § 2703 does not affect the respective contractual rights and obligations of the parties to an agreement to buy or sell the business interest.

**EXAMPLE:** Dad and Child are each 50% owners in a company and enter into a cross-purchase buy-sell agreement which provides that, at Dad's death, Child will purchase his interest for $1,000,000. At Dad's death, the fair market value of his shares is actually $3,000,000 and the three requirements to the IRC § 2703 exception have not been satisfied. The $1,000,000 buy-out price set in the agreement is disregarded for purposes of valuing Dad's stock for estate tax purposes and his stock is subject to federal estate tax at its $3,000,000 value. However, Dad's estate is still contractually obligated to sell his stock to Child for $1,000,000. Assuming an estate tax rate of 50%, Dad's estate will have to pay estate tax of $1,500,000 with respect to his interest but will receive only $1,000,000 from Child under the buy-sell agreement.

IRC § 2703(b) provides an exception to the general rule in IRC § 2703(a), by setting forth

the following factors that, when met, will enable restrictions on the disposition of a business interest to be taken into account for purposes of establishing transfer tax value:

- The agreement must be a bona fide business agreement;
- The agreement must not be a device to transfer the business interest to members of the decedent's family without full and adequate consideration; and
- The terms of the agreement must be comparable to similar arrangements entered into by persons in arm's-length transactions.

Each of these three requirements must be independently satisfied. Treas. Reg. § 25.2703-1(b)(2). A right or restriction is considered to meet each of the above requirements "if more than 50% by value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family." Treas. Reg. § 25.2703-1(b)(3). The definition of a "family member" includes lineal descendants of the transferor's parents or the transferor's spouse's parents. Also included in the definition of a "family member" is "any other individual who is a natural object of the transferor's bounty." See Treas. Reg. §§ 25.2703- 1(b)(3); 25.2701-2(b)(5).

**d. Arm's Length Transaction**. Many of the cases considering buy-sell agreements focus on the third prong of the test set forth in IRC § 2703(b). A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing at arm's length. Treas. Reg. § 25.2703-1(b)(4). Factors to be considered generally include: (1) the expected term of the agreement; (2) the current fair market value of the property; (3) the anticipated changes in value during the term of the agreement; and (4) the adequacy of any consideration given in exchange for rights granted.

**e. Modification of Restrictions.** Any restriction imposed on the disposition of a business interest prior to October 8, 1990, if the agreement or arrangement containing such restriction is substantially modified after October 8, 1990, also will be subject to the requirements of IRC § 2703. According to Treas. Reg. § 25.2703-1(c)(2), the term "substantial modification" does *not* include:

- A modification that is required by the terms of a right or restriction;
- A discretionary modification that does not change the right or restriction;
- A modification of a capitalization rate provided it bears a fixed relationship to a specified market rate; and
- A modification that results in an option price that is closer to fair market value.

The regulations under IRC § 2703 also provide that any discretionary modification of a right or restriction that results in other than a *de minimis* change to the quality, value or timing of the rights of any party is a substantial modification. Additionally, the failure to update a right or restriction, which by its terms requires periodic updating, is presumed substantially to modify the right or restriction unless it can be shown that updating would not have resulted in a substantial modification. Treas. Reg. § 25.2703-1(c)(1).

→ **Planning Point:** Whenever the value of a business interest is being restricted pursuant to an agreement, or in any other manner, and the restricted value is being relied upon for transfer tax purposes, careful consideration of and adherence to IRC § 2703, its regulations and Treas. Reg. § 20.2031-2(h) is required. By complying with these requirements, the value of a business interest established in a buy-sell agreement or similar arrangement can be relied on for transfer tax purposes.

**2. Treatment of Certain Restrictions and Lapsing Rights: IRC § 2704**

IRC § 2704(a) applies to lapsing liquidation and voting rights and provides that a lapse is a transfer subject to estate, gift or GST tax by the individual holding the lapsing right. The amount of the transfer is the excess of the value of the transferred interest before the lapse over the value of the interest after the lapse. IRC § 2704(a) only applies if the interest holder and the members of his family control the entity immediately before and after the lapse.

> **EXAMPLE:** A general partner dies and the general partnership interest is converted to a limited partnership by reason of the death of the general partner and passes to the general partner's son. IRC § 2704 (a) treats as a transfer the difference in the value of the decedent's general partnership interest and the value of the estate's limited partnership interest.

> **EXAMPLE:** D owns 84% of the single outstanding class of stock of corporation Y. The bylaws require at least 70% of the vote to liquidate Y. D gives one-half of D's stock in equal shares to D's three children. IRC § 2704 (a) does not apply to the loss of D's ability to liquidate Y, because the voting rights with respect to the corporation are not restricted or eliminated by reason of the transfer. Treas. Reg. § 25.2704-1(f), Ex. 4.

Under IRC § 2704(b), if the governing instrument imposes an "applicable restriction," a restriction that is more severe than the default rules under state law, such restriction is ignored in valuing the interest for estate or gift tax purposes. The transfer at issue must be to a member of the donor's family and the family must control the entity immediately before the transfer.

> **EXAMPLE:** A provision in a partnership agreement might restrict a partner from dissolving the partnership, when this right is otherwise given to a partner under state law. IRC § 2704(b), if applicable, would treat the partnership interest as having the dissolution right otherwise provided under state law when determining the value of this interest for estate or gift tax purposes, thereby making it worth more than would be the case had the restriction on dissolution been taken into consideration.

→ **Planning Point:** Because state law plays such a vital role in the application of IRC § 2704, practitioners should use the laws of those states that impose restrictions on the right of a limited partner or member to (1) withdraw from

the entity, (2) liquidate or dissolve the entity and (3) transfer interests in the entity.

**3. Valuation Freezes**

The planning objective in any valuation freeze is to make a gift of property during the grantor's lifetime and allow the transferred property to appreciate outside the grantor's estate. The property can be given to an irrevocable trust or to individuals outright. By giving the property during the grantor's lifetime, the value of the property can be frozen for transfer tax purposes and any appreciation that occurs after the gift is made is not included in the grantor's estate.

Valuation freezes can be accomplished by making lifetime gifts through a number of different planning vehicles, such as the vehicles discussed below.

**a. Grantor Retained Annuity Trusts.** The Grantor Retained Annuity Trust ("GRAT"), the Grantor Retained Income Trust ("GRIT"), and the Grantor Retained Unitrust ("GRUT") involve an immediate gift of a remainder interest in property, thereby freezing the value of the remainder interest for transfer tax purposes. For all three trusts, the grantor retains an interest in the trust for a term of years. The remainder interest is transferred to the beneficiaries of the trust after the grantor's retained interest expires. By making a gift of the remainder interest in trust during the grantor's lifetime, the grantor can freeze the value of the remainder interest at the date the trust is established. The remainder interest appreciates outside the grantor's estate and is transferred to the remainder beneficiaries without any further gift or estate tax, provided the grantor dies after the expiration of the retained interest.

The grantor retains the right to an annuity amount with the GRAT, the right to an income interest with the GRIT, and a right to a fixed percentage of trust assets with the GRUT.

**b. Qualified Personal Residence Trust.** A Qualified Personal Residence Trust ("QPRT") freezes the value of a personal residence or a second/vacation home. The grantor transfers the residence to an irrevocable trust and retains the right to occupy the residence rent-free for a term of years. The remainder interest is given to the beneficiary of the trust, usually the grantor's children. The amount of the gift is the present value of the remainder interest using the applicable remainder factor in Table B. By making a gift of the remainder interest during the grantor's lifetime, the value of the gift is frozen for gift tax purposes. The property can appreciate for the benefit of the children outside of the grantor's estate and be transferred to the children without any further gift or estate tax, provided the grantor dies after the expiration of the term.

➔ **Planning Point:** A non-partition agreement can be used with a QPRT to significantly reduce the value of a jointly-owned residence and thereby reduce the amount of the remainder gift to the beneficiaries.

**c. Family Limited Partnerships and Limited Liability Companies.** Family Limited Partnerships ("FLPs") and Limited Liability Companies ("LLCs") are planning vehicles used to freeze the value of assets. A variety of different types of properties can be transferred to an FLP or LLC. Due to the restrictions embodied in the FLP or LLC agreement, substantial valuation discounts often are taken on gifts of FLP or LLC interests. The value of the FLP or LLC

interest transferred is determined on the date the gift is made and any appreciation that accrues thereafter on the gifted property is outside of the grantor's estate.

**d.** **Sale to an Intentionally Defective Grantor Trust**. In a sale to an intentionally defective grantor trust ("IDGT"), the grantor sells property at its fair market value to the IDGT in return for an installment note. At the end of the note term, any income and appreciation on the trust assets that exceed the payments required to satisfy the promissory note pass to the beneficiaries of the trust free of estate, gift and GST taxes.

A promissory note bearing interest at the applicable federal rate ("AFR") under Section 1274(d) is deemed to have a fair market value equal to its face amount. Therefore, the sale of assets to the IDGT in return for a promissory note will not be a gift as long as the promissory note equals the value of the property transferred and bears interest at the AFR. An accurate appraisal is essential to support the fair market value claimed in the transaction.

Gift tax concerns may arise if the property that is the subject of the sale is a hard-to-value asset, such as closely held stock. A taxable gift will occur if the value of the property transferred is later determined to be greater than the sale price. Section H. below discusses the most common methods used to minimize the risk that the IRS will increase the value of the property transferred.

**4. Negotiated Securities Accounts[2]**

A Negotiated Securities Account ("NSA") limits the control an owner has over a securities account and shifts the management and investment responsibilities to an account manager. The owner agrees not to withdraw any funds from the account for a term of years and the account manager is given wide discretion to invest and reinvest the funds in the account. Due to the restrictions imposed on the NSA structure, discounts can be taken for valuation purposes. The NSA is intended to compete with and sometimes replace the FLP or LLC structure. The obvious advantage of the NSA is that it is much easier to set up and less costly to maintain than an FLP or LLC.

**a.** **Structure of NSAs.** An NSA is created by depositing funds in a managed account with a bank or trust company (not a registered investment advisor). An agreement is then entered into by and between the owner and the account manager. Under the terms of the agreement, the owner is not allowed to withdraw the funds for a specified term of years (*e.g.*, 5 to 10 years) and the account manager has the discretion to invest and reinvest the assets in the account pursuant to a long-term investment strategy that has been previously agreed to by the owner. The owner of the account can give the account or a portion of the account to his or her spouse, children and grandchildren, but the account, or the portion transferred, would remain subject to the restrictions placed on the owner's account.

**(1)** **NSA Agreement Term.** The term of the NSA agreement is a critical point in the negotiations between the owner and the account manager. Obviously, the longer the term, the more leverage the owner would have to negotiate a lower management fee. Additionally, a longer term will result in a larger valuation discount over the assets in the NSA for transfer tax purposes.

➔ **Planning Point:** The owner can extend the term of the agreement annually after the expiration of the first year so that the restrictions on the account are in place for the desired term of years. For example, if the initial term of the agreement is for six years, after year one, the owner can extend the agreement by one year so the six-year term of restriction on the account is maintained. The reason the owner would consider extending the restricted term in this manner is to ensure that the restriction period on the account is in place for a minimum number of years in order to maximize the amount of the discount to which the owner would be entitled if he or she were to die. The account also could have an automatic renewal provision. After the first year, the restricted term can automatically renew for another year to preserve the six-year term of restriction over the account. This would ease any administrative inconvenience on the owner to maintain the account. The owner also could consider an automatic renewal that would occur only after the end of the restriction period, but this alternative would limit the size of the discount if the owner dies near the end of the restriction period.

**(2) NSA Formation Considerations.** It is important for the owner to be comfortable with the restrictions on the NSA. The owner must select a term of years that, on balance, will provide the desired discount and not unduly burden or restrict his or her ability to obtain unfettered control over the account in the future. The owner also must determine who will be the permitted transferees of the NSA. Should the permitted transferees be limited to family members or also include unrelated parties? Finally, it is essential that the owner select an account manager that he or she is comfortable working with. When selecting an account manager, the owner should keep in mind that the NSA cannot be transferred to another account manager or terminated without the mutual consent of the owner and account manager. The account manager also should not be a related person as defined in IRC § 267(b) or a subordinated person as defined in IRC § 674(c).

**(3) NSA Income Distributions.** The owner of an NSA could require a distribution of all or a specified portion of the income earned in the account; however, such a requirement likely would decrease the amount of the discount because the owner would have the use and enjoyment of such property. By allowing the NSA to retain all of its income, the restrictions on the use and enjoyment of the property will be maximized and thereby the available discounts also will be maximized.

**(4) NSA Business Purpose.** The business purpose for entering into an NSA agreement is to allow the account manager to pursue a long-term investment strategy that should increase the overall performance of the investment. In exchange, the owner should receive a reduced management fee for the management of the NSA since the account manager would control the account until the expiration of the term of the NSA agreement.

➔ **Planning Point:** An NSA agreement is an agreement between the owner and an account manager. Since the owner does not have the power to unilaterally change the terms of the agreement, all of the issues that are of concern to the owner, (*e.g.*, permitted transferees, account manager duties, management fees, investment strategy, investment goals, and diversification of assets) should be thoroughly discussed and agreed upon

before the NSA agreement is signed.

**b.** **Discounting the Value of the NSA.** The NSA utilizes two discounting principles: lack of marketability and lack of control. Both discounts can be utilized to reduce the value of the NSA for gift and estate tax purposes. The agreement entered into between the owner and account manager usually restricts the transfer of the NSA to anyone other than the owner's spouse, children, and grandchildren. Even after the owner transfers the account or a portion of the account to a spouse, child, or grandchild, the same restrictions on the NSA would remain in place. Therefore, the NSA lacks marketability. The owner also does not have control over the management and investment decisions of the account and cannot unilaterally terminate the agreement or transfer the account without the consent of the account manager. Therefore, the owner lacks control over the account.

A transfer of the NSA by gift should be delayed for a reasonable period of time after the account is created so that the IRS cannot assert a position that, pursuant to IRC § 2703, the NSA was merely a device to transfer property to the next generation for less than full and adequate consideration.

> **EXAMPLE:** X owns $3,000,000 worth of securities in a managed account at a bank or trust company that is not a registered investment advisor. X and the account manager enter into an NSA agreement for a six-year term. The account manager has the exclusive right to manage and invest the account for the six-year term. X cannot withdraw the funds from the account, has no authority over the management and investment of the account assets, and can transfer the account, or an interest therein, only to his spouse, children and grandchildren. The account manager agrees to reduce the management fee normally charged by 10% over the term of the agreement. The account can be terminated only by the consent of X and the account manager.
>
> One year after establishing the NSA, in 2010, X decides to transfer $1,000,000 of assets in the NSA to his son. The $2,000,000 worth of securities is distributed from the NSA to a separate account for the benefit of X's son. The application of the lack of control and lack of marketability discounts reduces the value of the gift by 35%. Therefore, the value of the gift would be reduced by $700,000 ($2,000,000 x 35%) resulting in a gift valued at $1,300,000 instead of $2,000,000. These discounts would result in a potential gift tax savings of approximately $311,000 (assuming X has a $1,000,000 applicable exclusion amount).
>
> Two years after establishing the NSA, X dies. X's NSA is then transferred to X's son. The remaining assets in X's NSA have a face value of $3,000,000 at X's death. When the remaining assets in the NSA are appraised, they will still be eligible for the combined 35% discount because the NSA is still subject to the original restrictions. The value of

the NSA in X’s estate would be reduced by $1,050,000 ($3,000,000 x 35%), resulting in a transfer of $1,950,000 ($3,000,000 - $1,050,000) for estate tax purposes. These discounts would result in an estate tax savings of up approximately $412,500 (assuming X utilizes a $1,000,000 applicable exclusion amount).

By using an NSA, X will be able to transfer securities worth $5,000,000 to X’s son and pay transfer taxes only on $3,250,000 ($1,300,000 + 1,950,000), thereby saving X the transfer tax on $1,050,000. While X’s son will still be bound by the restrictions imposed on the NSA, these restrictions will expire in four years.

**c. IRS Position on NSAs**

In Rev. Rul. 2008-35, 2008-29 I.R.B. 116, the IRS addressed the issue of whether, for both gift and estate tax purposes, valuation discounts are available for NSAs due to the restrictions imposed by NSAs on the assets it holds. The IRS presented the following factual situation. Taxpayer entered into a NSA with Bank pursuant to which Taxpayer agreed to deposit marketable securities and cash into the NSA. Bank advised Taxpayer that the NSA was designed to enhance the investment performance of the assets held by the NSA by allowing Bank to maximize the NSA’s long-term performance without the risk of withdrawal of assets from the NSA before the expiration of the NSA term. Bank agreed to accept a lower fee for its services because Bank was guaranteed this fee over the NSA term.

Bank had complete discretion regarding the management of the NSA assets. Taxpayer, however, held all property rights in the NSA assets under state law while Bank owned no such right. All income was reinvested. Taxpayer could nominate an investment advisor to be appointed by Bank, but Bank had the complete power to remove and replace such advisor. The NSA was to terminate after five years, subject, however, to extension of the NSA’s term upon election of Taxpayer and the consent of Bank. Upon termination of the NSA, all NSA assets were to be distributed to Taxpayer.

Taxpayer, with Bank’s consent, could transfer all or any part of the NSA to Taxpayer’s spouse, parent, descendant or an estate or trust established for the benefit of such transferee. The transferee would be bound by the NSA agreement and would have a property right in the transferred assets. Taxpayer would pay taxes on the NSA income. Individuals or entities that purchase the securities held in the NSA would not be subject to the NSA agreement.

The IRS explained that the NSA appreciated in value, and Taxpayer transferred one-sixth of the RMA to Taxpayer’s child during the NSA term. Taxpayer then extended the NSA term to seven years, but died in the fourth year of the term.

IRC § 2703(a)(2) states that the value of any property shall be determined without regard to any restriction on the right to sell or use such property. Under IRC § 2703(b), this rule under (a)(2) does not apply to a restriction: (1) that is a bona fide business arrangement; (2) that is not a device to transfer property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth; and (3) whose terms are comparable to similar

arrangements entered into by persons in an arm's length transaction. The IRS then stated that the legislative history of this statute confirms that it was intended to be applied to a broad range of property interests. Treas. Reg. § 25.2703-1(a)(3) further clarifies that a right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholder's agreement or any other agreement or may be implicit in the capital structure of an entity. The IRS then discussed *Estate of Smith v. United States*, 391 F.3d 621 (5th Cir. 2004), in which the court explained that, in determining the value of non-marketable retirement accounts, "[a]pplying the [willing buyer-willing seller] test appropriately . . . entails looking at what a hypothetical buyer would pay for the assets in the Retirement Accounts." The court in *Estate of Smith* refused to apply a discount for the anticipated income tax that would be incurred if the assets were distributed to the account beneficiaries. *See also Estate of Kahn v. Comm'r*, 125 T.C. 227 (2005).

Based on these authorities, the IRS concluded that implementation by Taxpayer of the NSA does not reduce the value of the assets held in the NSA for transfer tax purposes. The IRS explained that Taxpayer in the situation described above "at all times retains a property interest" in the NSA assets, while Bank holds no such interest. Notwithstanding the restrictions placed on the NSA, the IRS believed that Taxpayer "remains the sole and outright owner of the assets in the NSA and the income from those assets," and consequently has not changed the nature of Taxpayer's property by entering into the NSA agreement.

The IRS went on to explain that "[a]ny restrictions imposed by the NSA agreement relate to the performance of the management contract (*e.g.*, by establishing and ensuring a long-term investment horizon to be pursued by the manager, and an appropriate fee in light of this circumstance), rather than to substantive restrictions on the underlying assets held in the RMA." The IRS stated that an RMA is comparable to the retirement assets at issue in *Smith* and *Kahn* and to a situation in which the owner of rental real estate enters into a property management agreement regarding this real estate. The IRS said that "[t]he existence of the management contract has no effect on the fair market value of the real property subject to that contract." Therefore, the IRS concluded by stating that both IRC §§ 2036 and 2703(a)(2) applied to RMAs.

While the NSA simpler to create than a FLP or LLC and less expensive to maintain, the IRS has taken a firm stance against such an arrangement. Thus, any NSA should be carefully drafted and maintained so as to put the taxpayer in best position to distinquish the taxpayer's NSA from the facts and/or reasoning of Rev. Rul. 2008-35.

### H. Minimizing Valuation Risks in Lifetime Transfers

Anytime a donor makes a lifetime gift of property, there is a risk that the IRS will attempt to increase the value of the property reported on the gift tax return. If the IRS is successful, an unexpected gift tax liability may arise along with the associated interest and penalties.

Different methods are used to minimize the risk that the IRS will increase the value of the property reported on the gift tax return. This section will discuss the methods most commonly used to minimize that risk.

#### 1. *Procter* and Valuation Formulas

**a. General Rule.** The seminal case in the area of revaluation is *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944). *Procter* involved a transfer by gift to a trust. The trust provided that if a federal court of last resort held that any part of the transfer was a taxable gift, that portion of the property subject to gift tax would be excluded from the transfer. The court held that this was a condition subsequent and it violated public policy. The court stated that there were three reasons for declaring the condition subsequent void:

- It would deter the IRS from auditing returns because there would be no possibility to collect tax,
- The donees would not be parties to the tax litigation and might later try to enforce the gift and
- This type of provision would obstruct the administration of justice because as soon as a court rules that the value of the gift should be increased, the trust instrument revokes the gift and makes the court's ruling moot.

**b. Valuation Formulas.** The IRS and the Tax Court have continued to confirm *Procter*. See, e.g., *Estate of McClendon v. Comm'r*, T.C. Memo. 1993-459, *rev'd on other grounds*, 77 F.3d 477 (5th Cir. 1995); *Ward v. Comm'r*, 87 T.C. 78 (1986); Rev. Rul. 86-41, 1986-1 C.B. 300. Practitioners have responded by creating valuation formulas (also called "valuation definition clauses" or "defined value gifts") that attempt to avoid the risk of revaluation. One valuation formula specifies the dollar amount of the gift and then uses this dollar amount to calculate the portion of the property that would be needed to satisfy the amount of the gift. This valuation formula arguably avoids the creation of a condition subsequent and the transferring of property back to the grantor. In other words, the donee never has a right to the portion of property that exceeds the specified dollar amount. While the IRS appeared at first to favor these valuation formulas (see, e.g., TAM 8611004, in which the IRS granted the ruling requests of a taxpayer who transferred "such interest in X partnership as has a fair market value of $13,000," although neither one of the issues at stake concerned the validity of this formula), the IRS has subsequently ruled that these clauses are invalid. In TAM 200337012, the donor transferred "that fraction of Assignor's Limited Partnership Interest" that has a fair market value equal to a dollar amount specified in the assignment agreement. The taxpayer reported the transfer on a federal gift tax return as a gift of a specific percentage partnership interest with a value of $5,000 less than the dollar amount mentioned in the deed of gift. Relying on the above- cited cases and ruling, the IRS stated that the formula gift clause was ineffective for gift tax purposes because it violated public policy. The IRS saw no difference between a valuation clause such as the one at issue in this TAM and the revaluation clauses in *Procter* and its progeny.

Other valuation formulas have not been any more successful. In TAM 200245053, the taxpayer, as trustee of a revocable trust, sold a fractional share of a 98.9% limited partnership interest to his irrevocable trust. The fraction used to determine the share of the limited partnership interest had a numerator equal to the stated purchase price and a denominator equal to the fair market value of a 98.9% interest in the limited partnership interest. The sale agreement stated that the fair market value of the limited partnership interest "shall be such value as finally determined for federal gift tax purposes." The sale agreement stated that the parties reached a tentative agreement that the percentage interest transferred was the revocable trust's entire interest. The sale

agreement also stated that the agreement may be modified if the IRS determines that the sale actually conveyed a different percentage than 98.9%. Upon such a determination by the IRS, the ownership interests and prior distributions would be adjusted. The IRS stated that this clause was against public policy, relying on *Ward* and Rev. Rul. 86-41. The IRS stated that the formula was an "attempt to ameliorate any adverse consequences if the Service challenged the transaction and thereby to discourage any such challenge," and that the clause "does not serve a legitimate purpose."

While the IRS may disfavor valuation formulas, the U. S. Court of Appeals for the Fifth Circuit may have given some hope for the validity of these formulas. In *McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006), the taxpayers formed a limited partnership to hold various investment assets, including stocks, bonds, real estate and other limited partnership interests. The taxpayers then gave partnership interests to their children and certain charities under a formula clause that purported to give (a) $6,910,933 worth of partnership interests to the taxpayers' children and trusts for their benefit; (b) $134,000 worth of partnership interests to the Shreveport Symphony (but not more than the difference between the value of the total gift and the amount allocated to the children and their trusts) and (c) the balance to a second charity (later determined to be $324,345). The donees were required, without any involvement by the taxpayers, to determine the value of the partnership interests and to allocate the gift among themselves using gift tax valuation methods. The IRS valued the total gift at $12,426,086, and declined to recognize the validity of the formula clause, upholding its position in FSA 200122011, which dealt with a similar formula.

The Tax Court determined the value of the total gift to be $9,883,832. The gifts were calculated on the basis of the fair market value determined by the Tax Court and the percentage interests transferred as independently determined by the donees. The court then stated that the specific formula clause might be valid to limit the amount given to the children and their trusts, but that it did not create a charitable deduction for the entire additional amount passing to the charity because it relied on the valuation fixed by the donees, rather than one fixed by the courts. The court stated that it did not, therefore, have to reach the question of whether such a formula clause would be enforced if it was tied directly to the gift tax values set by the court. The court stated, however, that it might have allowed the larger charitable deduction had the agreement given each donee the "enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes." The taxpayers could, therefore, deduct as the gift to the second charity for gift tax purposes only the amount actually allocated to the second charity by the donees' agreement, rather than the difference between the court's valuation of the gift and the amount allocated to the children and the Shreveport Symphony, thus creating a $2,514,554 net additional taxable gift. ($9,883,832 - $7,044,933 - $324,345).

On appeal, the Fifth Circuit was very critical of the Tax Court's analysis and dismissed any positive language concerning the validity of valuation formulas that one may have taken from the Tax Court's opinion. However, the Fifth Circuit, in reversing the Tax Court, still indicated that valuation formulas may be generally valid. The Fifth Circuit stated that the Tax Court should have not considered events after the date of the gift, such as the donees' agreement, especially when the taxpayers were not parties to such agreement. The Fifth Circuit also found the transaction was not abusive.

Because the Tax Court rejected the IRS's expert's valuation, and because of the Fifth Circuit's finding that the Tax Court erred in its own valuation, the Fifth Circuit found that the only usable valuation for the transferred interests was the taxpayer's appraisal, which led to the value of the gifts being determined as reported on the taxpayer's gift tax return.

➔ **Planning Point:** Although *McCord* was a very taxpayer-friendly decision, its reliability may be severely limited because the IRS did not discuss in its brief the traditional policy arguments against defined value formulas discussed above. The IRS has attempted to use these arguments in at least one case post-*McCord*. See *Dallas v. Comm'r*, T.C. Memo. 2006-212, n.19.

**2. Other Techniques to Minimize Valuation Risks**

The Marital Formula and Charitable Formula are variations on the general valuation formula described above and also are used to avoid the risk of revaluation.

**a. Marital Formula**. The marital formula provides that any part of a transfer that is determined to be a taxable gift is redirected to the spouse or a trust for the spouse's benefit. If the IRS increases the value of the property reported on the gift tax return, the marital formula would direct the taxable portion of the gift to the spouse or to a Qualified Terminable Interest Property ("QTIP") trust for the benefit of the spouse and thereby use the marital deduction to eliminate any gift tax liability.

The primary concern in using the marital formula is that it redirects the excess gift away from the trust beneficiaries and gives the property to the spouse or to a trust for the benefit of the spouse. Since the redirection of the excess gift would occur only after an audit, the marital formula also may appear to be more of a condition subsequent and therefore invalid.

➔ **Planning Point:** As a practical matter, marital formulas are not frequently used because of the risk of divorce. If the parties divorce, the excess gift cannot be diverted from the former spouse because an irrevocable gift already has been made. The former spouse would have full control over the gifted property and could transfer the property to whomever he or she wished.

**b. Charitable Formula**. The charitable formula is similar to the marital formula except that the excess gift is transferred to a charity rather than the spouse or a QTIP trust. See *McCord*, supra. The charity can be a public charity or the grantor's private foundation.

The use of the charitable formula is subject to the same concerns as the marital formula described above. The IRS could argue that the charitable formula is a condition subsequent and therefore invalid. The charitable formula also will prevent the grantor's family from ever

succeeding to the property. If the amount of the excess gift is substantial, a larger than expected gift away from the grantor's family may occur.

**3. Protective Limited Power of Appointment[3]**

The Protective Limited Power of Appointment ("Protective LPA") is similar to the valuation formulas in that it protects against the revaluation of assets and imposition of additional gift tax. However, the Protective LPA does not change the beneficiary or change the characterization of the gift.

**a. Structure of the Protective LPA**. The Protective LPA may be used in an irrevocable trust. The trust provides that upon receipt of property from the grantor for less than adequate consideration (a gift), the property is divided into a "Protective LPA share" and a "non-Protective LPA share." The Protective LPA share receives that portion of the gift that exceeds the specified dollar amount of the gift (*i.e.*, the difference between the grantor's specified dollar amount of the gift reported on the gift tax return and the increased value of the gift determined by the IRS). The non-Protective LPA share receives the balance of the property gifted. The grantor is given an *inter vivos* and testamentary limited power of appointment over the Protective LPA share. Therefore, the grantor can appoint the Protective LPA share to anyone other than the grantor, his or her creditors, his or her estate, or the creditors of his or her estate.

Since the grantor reserves the power over the Protective LPA share to name a new beneficiary or change the interests of the existing beneficiaries, the gift of the Protective LPA share to the trust is not a completed gift pursuant to Treas. Reg. § 25.2511-2(c).

**b. Revaluation Risk of the Protective LPA.** The Protective LPA reduces the risk of revaluation (i) without changing the identity of the donee or the amount of the gift, and (ii) without eliminating the IRS' incentive to audit. The grantor would transfer the property to the trust and the property would be held in trust, subject to the terms of the trust agreement. The grantor would retain a power to alter the beneficiaries or to change the interests of the existing beneficiaries. If the IRS were to increase the value of the gift, an allocation of the excess gifted value would be made to the Protective LPA share. The grantor of the Protective LPA share would retain a limited power of appointment over that property. Since the Protective LPA share is defined at the outset of the transfer to the irrevocable trust, there is no condition subsequent.

The Protective LPA would not deter the IRS from auditing the gift tax returns. Since the Protective LPA share is included in the grantor's estate as a retained interest, the IRS has an incentive to audit the gift tax return to ensure that the value of the property allocated to the non-Protective LPA share is proper. If the IRS is able to increase the value of the gift, the excess could be added to the Protective LPA share, thereby increasing the size of the grantor's estate.

The IRS has recognized the use of a similar general power of appointment based on a formula in PLR 9110054. The general power of appointment-based formula operated over that portion of the trust that was not exempt from the generation-skipping transfer tax.

➔ **Planning Point:** The Protective LPA and the valuation formulas can be used on the same gift. The grantor would then have a safety net against the risk of revaluation if one method fails. The grantor also should consider exercising the Protective LPA in favor of a marital trust to defer any estate taxes.