Trusts & Estates Valuation Update:

The Latest on Cases, Audits and the Environment[1]

January 2015

If it was not clear already, we are in a period where many estate planners are increasing their focus on matters other than the federal exemptions. Some practitioners are contemplating the balance between minimizing estate and gift tax with minimizing income tax, while simultaneously giving consideration to asset protection, business continuity, and the proper management and transition of investments. To some this is viewed as a paradigm shift, while others have not been so quick to change course or dismiss the techniques that have been tested, refined and used so successfully for many years. The phrase "it depends" comes to mind – that is, it depends on who the client is, the type of assets he/she owns, and the myriad considerations unique to that person's circumstances. The consideration of any estate plan are far too many to list, and the complexities of the tax code at both the federal, state and local level have not subsided and are by no means permanent.

Starting with the basics, the passage of ATRA[2] made "permanent" unified exemption amounts of approximately $5.0 million per person and $10.0 million per couple (indexed to inflation after 2011), and reset the maximum estate tax, generation skipping tax ("GST") and gift tax rate to 40%. The exemption is $5.43 million for 2015, or $10.86 million for a married couple. However, the word "permanent" is in quotes for a reason – there is no guarantee that these rules will not be revisited and/or revised in the future. In fact, for the second year in a row, President Obama's budget for fiscal 2015 proposed lower exemption amounts and higher estate tax rates. In his State of the Union Address, the President called for an end to the current "step-up" in the tax basis of appreciated assets at death.

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[1] This piece has been prepared for informational purposes only, and is not meant to be and should not be construed as legal advice or used as a substitute for legal advice from a credentialed legal professional.

[2] On January 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012 ("ATRA"), avoiding the so-called "fiscal cliff" and making "permanent" many of tax cuts that were enacted during President Bush's term in office, with some modifications.

But changes in tax law and family dynamics are not the only moving parts when evaluating estate planning alternatives. Not to be lost in the shuffle is a primary driver of estate planning – the uncertainty of future asset values. Improving economic and market conditions, coupled with continued operating successes, may well drive business values higher. Clients with balance sheets presently below the taxable threshold expect and plan for growth. Moreover, there is no way to be sure of when a client will pass on, what their net worth will be at that time, what federal exemptions and tax rates will be, how state laws will change between now and then, and how family dynamics will evolve.

So with these premises, how critical is it that a family today has a net worth of $8.0 million, and a patriarch/matriarch in, say, his/her fifties, in a world with (for the time being) a combined marital estate tax exemption of $10.86 million? I submit to you that things are not as clear in this "new paradigm" as it may appear. That client may think/expect that his/her primary asset will be worth $20 million in ten years, and that his/her family will have other significant assets. In addition, the hyper-focus on today's combined $10.86 million marital exemption may be misplaced, since not all persons get married, the divorce rate in the U.S. is strikingly high, and "permanence" in the tax code is a misnomer.

Moving on, let us summarize the latest goings-on in the valuation community and with MPI's clients in the last twelve months. The frequency of tax court cases has not been as high as in years past, but cases such as **Richmond, Adell, Elkins, Giustina,** and others have important takeaways and ramifications:

- **Richmond** reminds us that qualified appraisals from qualified, credible and experienced valuation professionals is a must, and that the penny-wise, pound-foolish approach to filing estate and gift tax returns is exactly that, and can lead to significant IRS penalties. The conclusion on the BIG Tax issue was curious due to numerous preceding BIG Tax cases, but the taxpayer exited court with an overall discount of 47%.
- The Court held in **Adell** that a personal goodwill charge against earnings equating to 40% was appropriate and would allow a buyer to keep the son of the decedent (who had no contract or non-compete) employed at a market rate given his role as a significantly key person. The IRS expert applied a 20% DLOM on this controlling interest.
- The Elkins reversal in the Fifth Circuit was a homerun decision for taxpayers with fractional interests in hard assets, as the Circuit Court's decision legitimized fractional interest discounts in art, made the IRS look imprudent for its attempt to wipe out discounts entirely, and overturned a 10% discount subjectively determined by the Tax Court. Discounts between 50% and 80% were sustained and the taxpayer took the results all the way to the bank in the form of a $14.4 million refund.

- Most recently, the Ninth Circuit found "clear error" and remanded the **Giustina** matter back to the Tax Court, requiring it to recalculate the partnership's value as a going concern, rather than based on liquidation and the use of "imaginary scenarios." While this matter remains open, a favorable outcome for the taxpayer could be a watershed moment in the valuation of partnerships holding timberland, farmland, ranchland or other low returning real estate.

On the audit front, despite its limited resources, the IRS continues to audit the estate tax returns of high net worth decedents at a high rate.[3] The audit rate on gift tax returns has dropped, but remains meaningful in the area of investment partnerships, real estate entities and any hard-to-value assets containing substantial valuation discounts. More than ever, it is critical that taxpayers invest in a qualified appraisal from a reputable and established valuation firm that is capable, prepared and experienced in handling estate and gift tax audits. Many of you are aware of MPI's latest work on discounts for lack of marketability.[4] Armed with our published study, we have seen a string of positive audit results for clients over the last eighteen months. Much of this can be attributed to the increased leverage we now have in audit discussions, as the IRS cannot match the quality, reliability and customization that MPI brings to the development of discounts for lack of marketability. Moreover, MPI's study is unmatched in the industry due to the depth and quality of its underlying data, which now spans 30 years, includes over 2,000 private placement transaction observations scrubbed by our own staff, and contemplates nine out of a tested 50 company specific and market specific factors on the transaction date.

In closing, the complexities involved in estate planning, dynamics of families and business ownership, hotly debated valuation topics, and myriad of related issues is what makes the estate planning and valuation professions so unique, challenging and rewarding. Here's hoping that no matter what changes in the tax code, those attributes remain. MPI looks forward to working with you and your clients in 2015.

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[3] The all-in rate of estate tax return audits in 2013, as estimated by Michael Gregory, formerly of the IRS, was 33%. However, if we focus on the subset of estates characterized by ultra-high net worth decedents and/or illiquid assets subject to valuation discounts, the audit rate was likely close to 100%.

[4] "Regression Analysis and Discounts for Lack of Marketability," Business Valuation Review, Volume 30, Number 1. The study cited has since been updated to include data through 2010.

About MPI

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

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