Valuation Insights

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Gifting in 2010

As of the writing of this newsletter, it appears less and less likely that Congress will pass any transfer tax reform in 2010. As a result, 2010 could be the best of times for gifting by affluent clients for the following reasons: (1) There are historically low applicable federal rates that encourage certain gifting strategies; (2) Low asset values, particularly in real estate and family businesses help individuals to give more away than they could at higher values; (3) There is proposed legislation to reduce or eliminate intra-family transfer discounts in the near future; (4) The gift tax rate is only 35% for 2010; (5) Due to the lack of action by Congress, there is an increasing probability of restoration of the 2001 transfer tax rules in 2011, with the estate tax exemption going to $1.0 million and the transfer tax rate at 41-60%; (6) Clients who gift will benefit from a shifting of income in future years as there will likely be significant increases in state and federal income tax rates in the coming years. Furthermore, the spread in income tax rates at the upper and lower ends of taxation will likely increase in future years. My guess is that for most professionals in the estate planning field, we will likely see a flurry of activity in the last three to four months of this year.

ESOP Update

HR 5207 (the "Employee Stock Ownership Plan Promotion and Improvement Act of 2010") has been introduced in the House of Representatives. This bill would: (1) eliminate the 10% penalty tax on distributions made directly to participants in S-corporation ESOPs; (2) exempt qualifying dividends paid on ESOP shares from AMT calculations; (3) allow sellers of stock to qualifying ESOPs in S-corporations to take a deferral of gains under Section 1042 of the Code (this is currently only available to C-corporations); (4) allow sellers to ESOPs taking a deferral of gains in the proceeds to invest in certain mutual funds; (5) redefine 25% ownership for purposes of Section 1042 of the code to mean owners of 25% or more of all the voting shares or the total value of all the shares; and (6) redefine a business that otherwise meets the definitions of a small business under various federal loan and procurement programs to include those that are more than 50% owned by an ESOP. It will be interesting to see how this progresses.

SBA Lending – HOT and COLD

The U.S. government has kept SBA lenders on their toes in the first half of 2010 with the fee waiver and 90% guarantee on 7(a) loans being on a roller coaster ride of multiple extensions and expirations. As of the end of July, there is pending legislation that would extend these incentives once again. However, how long or when these incentives will be extended again is anybody's guess at this point. The 90% guaranty for SBA 7(a) loans has been a major contributor to the increase in SBA loan volume because it provides lenders with the higher guaranty. Without this guaranty, the loan volume has dropped off dramatically. We'll see what happens in the next few months!

Did You Know:

According to the Tax Policy Center, if a $1 million exemption amount per decedent is applicable in 2011, there will be an estimated 43,500 estates subject to tax. However, if the 2009 exemption amount of $3.5 million per decedent is applicable next year, the number of taxable estates is reduced to 6,500.

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Suzanne J. Pierre, Petitioner v. Commissioner of Internal Revenue Service, Respondent, T.C. Memo 2010-106, Dated May 13, 2010

The Facts:

In the first Pierre case, Pierre v. Commissioner, No. 753-07, dated August 24, 2009 ("Pierre I"), the Court found that Ms. Pierre's single member LLC, the Pierre Family LLC ('the LLC"), was not a disregarded entity for gift tax valuation purposes under the "check the box" regulations of sections 301.7701-1 through 301.7701-3, Procedural & Administrative Regulations. As such, transfers of an interest in the LLC were treated as transfers of an LLC interest and subject to discounts for lack of control and marketability, rather than as transfers of proportionate shares of the LLC's underlying assets.

In this case, the Court was asked to decide two issues; (i) whether the step transaction doctrine applies to collapse Ms. Pierre's separate gift and sale transfers into transfers of two fifty-percent (50%) interests in the LLC; and (ii) whether the discounts for lack of control and marketability reported by Ms. Pierre should be reduced.

The Arguments:

Ms. Pierre argued that the four transfers (two gifts of 9.5% member equity interests and two sales of 40.5% member equity interests) of her entire interest in the LLC each had independent business purposes which preclude the transactions from being collapsed under the step transaction doctrine. Ms. Pierre provided several non-tax reasons for establishing the LLC but did not provide any non-tax reasons to support splitting the gift transfers from the sale transfers. The IRS argued that it was always Ms. Pierre's intention to transfer a fifty-percent (50%) interest in the LLC to each of the trusts established for the benefit of her son and granddaughter, and that Ms. Pierre only split the transfers to avoid paying gift tax. In addition, the IRS argued that the gift and sale transactions should be collapsed and treated as disguised gifts of 50% member equity interests to each trust to the extent their values exceeded the value of each trust's promissory note.

The Findings:

The Court agreed with the IRS on the step transaction issue for several reasons. The Court pointed out that Ms. Pierre had given away her entire interest in the LLC in the time it took to sign four separate documents, which all occurred on the same day. In addition, the record indicated that it was Ms. Pierre's intention to transfer her entire interest in the LLC to the trusts without paying any gift taxes. The Court found it compelling that Ms. Pierre's attorney, Mr. John Reiner, had recorded the transfers at issue as two gifts of fifty-percent (50%) interests in the LLC in his journal and ledger and that he had used these records to prepare the LLC's tax return. Although Mr. Reiner later testified that he had discarded these records due to inaccuracies, the Court found it difficult to disregard Mr. Reiner's original entries. Furthermore, the Court pointed to the fact that no principal payments had been made on either loan during the eight years in question, while the LLC continued to make yearly distributions to the trusts so that they could make the yearly interest payments on the loans. In addition, the Court found that nothing of tax independent significance occurred between the gift and sales transactions. The Court indicated it is appropriate to use the step transaction doctrine where the only reason that a single transaction was done as two or more separate transactions was to avoid gift tax. As such, the Court determined that Ms. Pierre had indeed transferred two fifty-percent (50%) interests in the LLC.

In regard to the determination of applicable lack of control and marketability discounts, the petitioner initially claimed a 10% discount for lack of control and 30% for lack of marketability (for a 36.55% cumulative discount). At trial, petitioner called upon an expert from Management Planning, Inc. ("MPI") who concluded that the appropriate discounts were 10% for lack of control and 35% for lack of marketability (for a 41.5% cumulative discount). The IRS did not introduce an expert at trial because of their position that gifts were of the underlying assets in the LLC. After discussing each discount in turn, the Court determined that a lack of control discount of eight-percent (8%) and a thirty-percent (30%) discount for lack of marketability were warranted on the transfers of the two 50% LLC member equity interests. The slight reduction in the minority interest discount from 10% to 8% occurred because the Court indicated that in valuing a 50% member equity interest, the owner of this interest could block the appointment of a new manager that previously the 9.5% minority interest valued could not. The IRS argued that the 35% lack of marketability discount utilized by the expert from MPI was too high, but failed to argue that the 30% lack of marketability discount actually applied in valuing the member equity interest in the LLC was inappropriate. Thus, the Court found that a 30% lack of marketability discount was appropriate.

Parting Thoughts:

While the step transaction decision was a victory for the IRS, the discounts were clearly a victory for the taxpayer. Regarding the step transaction, I expect that the decision may have been different if:

1. Mr. Reiner had not recorded the transfers at issue as gifts of two 50% member equity interests in the journal and ledger used to prepare the tax return but instead had shown them as a gift of a 9.5% equity interest and sale of a 40.5% equity interest. As seen in so many cases, a detailed paper trail can make a difference.
2. There had been some time elapse between the gift and the sale. For example, the 12 day period between funding of the LLC and transfer was deemed sufficient to not apply the step transaction doctrine in the Pierre I decision. Thus, it might have made a difference to separate the gift and sale transactions by another period of time.
3. Principal payments had been made on the notes. The case states that the notes were initially set up to be payable in 10 annual installments and an interest rate of 6.09%. The fact that no principal payments had not been made in the first eight (8) years of the notes did not bode well for the taxpayer.

Cubs Corner: Today, as I write this column, the Cubs sit 9 ½ games in back of the St. Louis Cardinals and there is five days left until the trading deadline. To say the season has been a disappointment is an understatement. Instead of envisioning a division title, Cubs management is envisioning which players can they trade away to either dump salary on contracts that have been total busts (Fukudome, Soriano, Zambrano) or still get something for instead of losing them to free agency in the offseason (Lilly, Lee, Nady). I have to admit, a small part of me still believes that the Cubs could pull off a turnaround similar to what the White Sox have done since June 1st and go on a streak of winning 25 out of 30 and still get back in this thing. However, I know the odds of that are very slim. Our starters are right at the top of the NL in terms of quality starts, but the offense has been a complete mystery. Rookies Colvin and Castro have been nice surprises while their high priced, proven players like Lee and Ramirez have been a huge disappointment. Piniella has said this is his last year and the managerial search in the offseason will be interesting. What hurts the most is that the Pirates, the worst team in the NL, has single handedly knocked the Cubs out of contention this year as the Cubs have a 3-9 record against them. Had the Cubs handled the Pirates the way they should have and gone 9-3 against them, the entire season would be different as they would be sitting only 3 ½ games out of first place. The Cubs seem to play at least .500 against the good teams, but can't seem to beat the teams they are supposed to beat! Until they can figure out how to do that, the drought will continue!

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