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Subject: **Valuation Discounts: Overview and Proposed Changes**

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THE CONCLUSION OF THIS WASHINGTON REPORT.**

As reported on in our Bulletins Nos. 09-50 and 09-10, both the Administration (in its recently released Greenbook -- "Certain Estate Tax Relief Act of 2009;" General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, Department of the Treasury (May 2009)) and Congress, in the form of legislation (H.R. 436) introduced by Rep. Pomeroy (D-ND), have proposed to limit the availability of certain entity discounts for closely held businesses. This report sets forth some of the background on the types of discounts that may be used to reduce the value of property for transfer tax (i.e., estate and gift tax) purposes, and summarizes the proposals to limit those discounts that have been available in the past.

A. Background.

The fair market value of property for transfer tax purposes is "the [hypothetical] 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) and 25.2512-1. The "willing buyer/willing seller" test may, particularly in the case of closely held businesses, be affected by a number of factors, including the ability to control the business, or

the ability to force its liquidation or sale, as well as limitations, such as those imposed on “restricted” securities, that make it less marketable to prospective purchasers. *See* Rev. Rul. 59-60, 1959-1 C.B. 237. Thus, the courts, as well as the Revenue Service, have recognized that discounts to net asset value may be allowable for “lack of control/minority interest” and/or “lack of marketability.”

1. Lack of Control/Minority Interest Discount. The shares of a corporation that represent a minority interest are usually subject to a minority discount, which is recognized because the minority shareholder lacks the general ability to cause the payment of dividends, compel liquidation, or control corporate policy. *See, e.g., Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981) (en banc); *Ward v. Commissioner*, 87 T.C. 78, 106 (1986); *Estate of Andrews v. Commissioner*, 79 T.C. 938, 953 (1982); *Harwood v. Commissioner*, 82 T.C. 239, 267 (1984), *aff'd. without published opinion* 786 F.2d 1174 (9th Cir. 1986). Similarly, a limited partnership interest or, in the case of a limited liability company (LLC), a non-management membership interest, which lacks the ability of a general partner to control the affairs of a partnership of LLC generally will be accorded a discount for lack of control. *See, e.g., Estate of Mirowski v. Commissioner*, T.C. Memo 2008-74, discussed in our Bulletin No. 08-49.

2. Lack of Marketability Discount. A “lack of marketability” discount reflects the absence of a recognized market for an asset and accounts for the fact that the asset is generally not readily transferable. *See, e.g., Estate of Litchfield v. Commissioner*, T.C. Memo 2009-21, discussed in our Bulletin No. 09-31; *Mandelbaum v. Commissioner*, T.C. Memo. 1995-255, *aff'd. without published opinion*, 91 F.3d 124 (3d Cir. 1996). In some cases, the lack of marketability is imposed as a result of external factors, such as the lack of a readily available market for non-publicly traded stock, and in others as a result of restrictions imposed in the entity documents, such as the mandated conversion of a partnership interest to an “assignee” interest upon any attempted transfer of the interest. *See, e.g., Hackl v. Commissioner*, 118 T.C. 279 (2002), *aff'd*, [335 F3d 664 \(7th Cir. 2003\)](#), discussed in our Bulletins Nos. 02-39 and 03-69. Marketability discounts can sometimes be created merely by placing an asset in a limited partnership or LLC.

The application of a minority discount and a marketability discount is multiplicative rather than additive. According to the Tax Court, the minority discount should be applied first and then the marketability discount should be applied to that figure. For example, a 20-percent minority discount and a 40-percent marketability discount should result in a 52- percent discount (20 percent + (40 percent x 80 percent)), not a 60-percent discount. *See Estate of Bailey v. Commissioner*, T.C. Memo 2002-152.

3. Other Discounts.

a. Fractional Interest Discount. A fractional interest discount arises from the lack of control inherent in joint ownership of an asset such as real estate or artwork. Such discounts often result in reductions in the value of transferred property of 15 to 60 percent. *See, e.g., Shepherd v. Commissioner*, 115 T.C. 376 (2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002), *rehearing, en banc, denied* 2002 U.S. App. LEXIS 14147 (2002), (*see* our Bulletins Nos. 00-100 and 02-67); *Estate of Forbes v. Commissioner*, T.C. Memo 2001-72, discussed in our Bulletin No. 01-50. The Revenue Service, however, often takes the position, sometimes successfully, that the amount of the discount should be limited to the costs of “partition” under state law. In a partition action, a court is asked to divide the property, assuming that the property is susceptible to partition, order the property sold intact, and divide the proceeds, or to split the property between the co-tenants. *See, e.g., Stone v. U.S.*, ___ F.2d. ___, No. 07-17068 (9th Cir. March 24, 2009), *aff'g*. 99 AFTR 2d 2007-2992, (N.D. Ca. 05/25/2007), discussed in our Bulletin Nos. 07-85 and 09-49.

b. Investment company discount

The investment company discount arises because the market values of closed-end mutual funds and investment companies often are less than the net asset values of those funds and companies. These discounts can sometimes be as high as 50 percent and may overlap with the marketability discount. *See Estate of Gillet v. Commissioner*, T.C.M. 1985-394.

c. **Discount for Built-In Capital Gains.** Prior to 1986, a corporate level tax could generally be avoided in the context of a corporate liquidation pursuant to the codification of the Supreme Court's decision in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). However, in the 1986 Tax Reform Act, Congress repealed the General Utilities doctrine and severely limited the ability to avoid a corporate level tax on appreciated corporate assets. As a result, a taxpayer may take a discount to the value of corporate stock (although perhaps not on a dollar-for-dollar basis) to reflect the "built-in gain" associated with the realization of the appreciation of the corporation's assets. *See, e.g., See, e.g., Estate of Litchfield v. Commissioner*, T.C. Memo 2009-21, discussed in our Bulletin No. 09-31; *Eisenberg v. Commissioner*, 155 F.3d 50, 57 (2d Cir. 1998) (*acq.* 1999-4 I.R.B. 4), vacating and remanding T.C. Memo. 1997-483; *Estate of Davis v. Commissioner*, 110 T.C. 530 (1998) (*see* our Bulletin No. 98-78); *Estate of Dailey v. Commissioner*, T.C. Memo. 2001-263 (*see* our Bulletins Nos. 01-91 and 02-137); *Estate of Borgatello v. Commissioner*, T.C. Memo. 2000-264.

B. *Judicial Attacks on FLP/LLC discounts.*

Because of taxpayer success in arguing the applicability of minority, marketability and other discounts, the Revenue Service, in estate tax cases, has in recent years attacked the family partnership/LLC on other grounds, notably Sections 2036 and 2038 (regarding transfers with retained interests and powers), by arguing, in many cases successfully, that an entity should be disregarded in its entirety where the transfer of assets to the partnership/LLC was not a "bona fide sale" for adequate and full consideration. There have been numerous cases decided under this theory, including *Estate of Schauerhamer*, T.C. Memo. 1997-242, *Estate of Reichardt*, 114 T.C. 144 (2000), *Estate of Harper*, T.C. Memo. 2002-121, *Estate of Abraham*, T.C. Memo. 2004-39, *aff'd* 408 F.3d 26 (1st Cir. 2005), *Estate of Hillgren*, 87 T.C.M. 1008 (2004), *Estate of Thompson*, T.C. Memo. 2002-246, *aff'd sub nom Turner v. Commissioner*, 382 F.3rd 367 (3rd Cir. 2004), *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2002), *aff'd in part rev'd in part sub nom Gulig v. Commissioner*, 293 F.3d 279 (5th Cir. 2002), *rehearing denied Gulig v. Commissioner*, 48 Fed. Appx. 108 (2002), *on remand at, judgment entered Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145, *aff'd Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005), *review or rehearing granted* 429 F.3d 1154 (5th Cir. 2005), *Estate of Kimbell*, 371 F.3d 257 (5th Cir. 2004), *Estate of Bongard*, 124 T.C. No. 8 (2005), *Estate of Bigelow*, T.C. Memo. 2005-65, *aff'd* 503 F.3d 955 (9th Cir. 2007), the companion *Korby* cases, T. C. Memo. 2005-102 and 103, *aff'd*. 471 F.3d 848 (8th Cir. 2006), *Estate of Schutt*, T.C. Memo. 2005-126, *Estate of Rector v. Commissioner*, T.C. Memo 2007-367 and *Estate of Jorgensen v. Commissioner*, T.C. Memo. 2009-66 (March 26, 2009). (*See* our Bulletins Nos. 00-43, 02-71, 02-78, 02-114, 03-56, 04-30, 04-42, 04-70, 04-110, 05-74, 05-77, 05-86, 07-11, 07-107, 08-23 and 09-49.) *But see Estate of Mirowski v. Commissioner*, T.C. Memo 2008-74, discussed in our Bulletin No. 08-49. The common reasoning in many of these cases is that, in order to have a bona fide sale - and thus a respected partnership - there must be a legitimate nontax reason (or business purpose) for the formation of the partnership.

C. *Legislative/Treasury Proposals*

1. **H.R. 436: "Certain Estate Tax Relief Act of 2009."** In January 2009, Rep. Pomeroy (D-ND) introduced a proposal that would freeze estate tax exemptions and rates at their current level, but would also significantly restrict the availability of entity discounts. H.R. 436 attacks marketability discounts by prohibiting any discount on "nonbusiness" assets held by an entity. Such assets shall be

valued for gift and estate tax purposes as if the transferor had transferred such assets directly to the transferee. The proposal attacks minority interest discounts by providing that no such discount shall apply to assets that remain under the control of the transferor and members of his/her family. H.R. 436's proposed effective date is "date of enactment." For further discussion, see our Bulletin No. 09-10.

2. General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, Department of the Treasury (May 2009) ("Greenbook"). In our Bulletin No. 09-50, we reported on the Treasury's proposed estate tax changes. Among them was a proposal to strengthen Section 2704(b) of the Internal Revenue Code, which was enacted as part of Chapter 14 of the Code. Section 2704(b) provides that, where a partnership or corporate interest is transferred to (or for the benefit of) a member of the transferor's family and, immediately before the transfer, the transferor and his family hold control of the entity, any "applicable restrictions" (including restrictions on the ability to liquidate the entity) are disregarded when valuing the transferred interest. Such restrictions are not disregarded, however, and will be given effect, if they are not more restrictive than state law provisions that would govern in the absence of provisions in the entity documents.

In *Kerr v. Commissioner*, 292 F.3d 490 (5th Cir. 2002), *aff'g* 113 T.C. 449 (1999), *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001) and *Estate of Harper v. Commissioner*, T.C. Memo. 2000-202 (see our Bulletins Nos. 02-77, 00-16, 01-16 and 00-88), the Tax Court held that restrictions on the right of a limited partner to withdraw from, or liquidate his particular interest in, a limited partnership is not an "applicable restriction" on liquidation of the entity that must be disregarded for valuation purposes under section 2704(b). The IRS has long disagreed with these courts' positions based on its own interpretation of the Treasury regulations.

The Treasury proposal would create an additional category of restrictions ("disregarded restrictions") that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. Specifically, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard identified in regulations. A disregarded restriction also would include any limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family. Regulatory authority would be granted, including the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met. The proposal would make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions.

This proposal would apply to transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of section 2704). It thus would apply to the transfer of existing property interests and, for this reason, should be regarded as more restrictive than the Pomeroy proposal.

* * * *

In summary, the importance of entity discounts, particularly of discounts to the value of interests in partnerships and LLCs (both of which may be used to hold life insurance, among other assets) cannot be minimized as an important estate planning tool. While they may continue to exist in the face of any estate

tax reform effort, they present a tempting target for revenue raisers. AALU will continue to monitor and report on efforts to limit or abolish entity discounts through the coming months.

Any AALU member who wishes to obtain a copy of any of the items discussed in this Washington Report may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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