

“How Appraisal Rules Are Made in Washington When You Are Not Looking...and What ASA Is Doing About It !” by J.L. Pierson, ASA¹

Joint Committee on Taxation Options To Improve Tax Compliance and Reform Tax Expenditures. Report # JCS-02-05 dated January 27, 2005 <http://www.house.gov/jct/s-2-05.pdf>

Section XI, sub-section B Estate and Gift Taxation: “Determine Certain Valuation Discounts More Accurately for Federal Estate and Gift Tax Purposes (IRC sections 2031, 2512 and 2624.)”

A. Proposed “Basic Aggregation Rule”

Pro-rata share of the FMV of the entire interest owned by the transferor just before the transfer.

Example One: Senior owns 80% of LLC; its asset value is \$100K. Senior makes 2 gifts of 20% each to children. The new rule values each gift at $20/80 \times \$80K$ or \$20K. Under existing law and practice, there would be a minority discount. Total proposed discount from pro-rata value [**prop.disc:** 0%.]

Example Two: Senior owns 40% of the LLC, worth, say 32% of assets value. There is a minority discount at the mother level, but not at children level. Each 20% is valued at \$16K. [**prop.disc:** 20%.]

Unfair because it taxes at more than FMV.

B. Proposed “Transferee Aggregation Rule”

If donor/estate does not control asset, but the transferee will have control after the gift, the gift is valued at the control level.

Example Three: same facts as One, but only one child; after transfers, child ends up with 80%. The value is computed at the control level, even as each transfer was at minority value. [**prop.disc:** 0%.]

C. Proposed “Look-Through Rule”

If transferred interest is part of a “controlling interest”² the look-through rule may also apply: If at least 1/3 of the entity’s assets are marketable securities, there is no minority discount and no lack-of-marketability discount on that portion of the transferred interest represented by securities.

Example Four: Decedent owns 80% of LLC; its assets are: marketable securities \$600K [over 1/3,] real estate \$200K, closely-held business \$200K. LOMD is 25% on the other assets. Value is equal to the sum of:

80% of securities or \$480K

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² By the donor before the transfer or by the donee after the transfer.

80% of real estate less LOMD or $\$200 \times 80\% \times (1-.25)$ or \$120K
80% of business less LOMD or $\$200K \times 80\% \times (1-.25) = \$120K$
Total: \$720K [**prop.disc: 10%.]**

Example Five: same facts except that marketable securities worth \$300K [30% or less than 1/3;] real estate \$100K and closely-held business \$0.6 million, total asset value \$1 million.

Look-through valuation rule would not apply; estate tax value of the 80% interest is \$0.8 million, less 25% LOMD or \$0.6 million. [**prop.disc: 25%.]**

Example Six: Same facts as Four, except that senior owns a 10% interest in the LLC. Donee/Beneficiary has no interest before the transfer. Look-thru value is pro-rata share less, say 20% minority discount, less 25% LOMD or \$60K. [**prop.disc: 40%.]**

In response, ASA's BV Committee's William Frazier, ASA met with JCT staff on 2/16/05 together with AI and made the following points. A meeting with the Senate Finance Committee is scheduled for the end of March.

(a) ASA and AI offer significant education and credentials. POV course curriculum and designation requirements were submitted to JCT. JCT also overlooked the AF, despite USPAP.

(b) There are adequate rules, decisions, etc. to administer the law. Competent appraisers understand that "value re-creation" is very much against public policy as per several court decisions. No appraiser would testify to discounts if the partnership was about to be unwound and the remaining partners were to obtain access to the assets. Strong limitations in the partnership agreements against partners unwinding the vehicle, and other rights-limiting realities make the discounts real.

(c) There is a body of knowledge which has been developed to support discounts which are facts driven, and based on observations in the market place. Discounts can be justified by both income and market approaches. This shows that discounts are not "manufactured".

(d) Strengthen the "qualified appraiser" rule and the problems will disappear. Better system for dispute resolution than relying on junior IRS engineers: solve the enforcement problem, beef up audit capabilities; charge a fee a la SEC; create a tax form for FLPs ?

Why It Is Important To Fight This:

JCT XI-B is based on junk science³ because there is no need for new rules, merely better enforcement of existing rules. JCT XI-B is a political creation in an environment with revenue-side pressure. It is contrary to current BV body of knowledge⁴. It is moving away from taxing transfers and into taxing assets at death; it is distancing itself from the concept of FMV. The alternative is to have rules with no regard to principles and facts, resulting in higher taxation.

³ The JCT paper was developed partially in response to concerns about perceived abuses in the "historical facade deduction" area; ASA last November made the same comments against "throwing away the baby with the bath water."

⁴ See in particular William Frazier "The process of determining the FMV of a limited partnership interest essentially replicates the investment behavior seen every day in the public marketplace for stocks and bonds" published by *Valuation Strategies* in its January/February 2005 issue.

and James R. Park, ASA Discounts in Family Limited Partnerships presented on May 7, 2004 at the ASA New York Chapter's Twelfth Annual Current Issues in Business Valuation.