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Estate, Gift and GST Taxes Redefined for 2010-2012

A new tax law was enacted effective Dec. 17, 2010, representing a reasonable compromise, and defining estate, gift and GST [generation skipping] taxes for 2010, 2011 and 2012 only. It has significant implications for owners of closely-held businesses: its gifting component alone provides a unique opportunity to shield hard-to-value assets from the gift tax once and for all, even if the new rules will clearly require many to revise their wills and other planning documents.

The estate, gift and GST taxes had been defined by prior law as follows: no estate tax for 2010, and indeed quite a few decedents with estates in excess of the exemption who were "lucky" to die in 2010 did not pay any such tax. The estate tax, as per the 2001 tax act, had a federal exemption of $1.0 million for 2011 and 2012 and a top rate of 55%.

Accordingly, the deal made between the President and the new Republican majority came as a pleasant surprise: for 2011 and 2012 the federal estate tax exemption is $5.0 million and the top rate 35%. For 2010, estates can elect not to pay the tax or to pay the tax with an exemption of $5.0 million and a top rate of 35%.

The basis adjustment at death, under prior law, was as follows: for 2010 it was limited to $1.3 million, plus $3.0 million passing to surviving spouse. For 2011 and 2012, the adjustment was to be equal to the property's fair market value ["FMV"] at the date of death or the alternate valuation date.

If a 2010 estate elects not to pay the tax, the adjustment is unchanged. If the 2010 estate elects to pay the tax, then the adjustment is equal to the FMV at the date of death or the alternate valuation date. 2011 and 2012 basis adjustment is now equal to the FMV at the date of death or the alternative valuation date.

Gift taxes under prior law had a federal exemption of $1.0 million and a top rate of 35% for 2010. Again under the old law, the 2011-2012 exemption was $1.0 million and the top gift rate 55%. Accordingly, the gift tax rules under the new law appear generous, and can offer planning opportunities.

For 2010, the federal gift exemption is $1.0 million, and it becomes $5.0 million for 2011 and 2012. The top rate is 35%.

This presents 2011 and 2012 only opportunities whereby the tax payer gifts property to his/her children without incurring the gift tax; moreover, the future appreciation is forever removed from his/her estate, and income could accrue to someone in a lower bracket. The $5.0 million lifetime exemption, particularly when combined with a spouse's, allows most business interests except the very largest to be transferred inside a family without gift tax. This decision by our government will be particularly welcome by "babyboomers" who have been building up businesses and have children now presumably capable of taking over. This is particularly true in a high-tax state like New York, which while it has a low estate exemption, has no gift tax.

No review of the new law is complete without covering the provisions of the GST tax. Under prior law, there was no GST tax in 2010, and 2011-2012 exemptions were $1.0 million and the top rate 55%. Under the new law, the 2010 GST exemption is $5.0 million and the tax rate 0%; the 2011-2012 exemption is $5.0 million and the top rate 35%. As of the date of this writing, the Service is busy drafting the forms!

Another "goody" is included in the new law: the portability of unused lifetime exemptions, which can be utilized by the surviving spouse for both gift and estate tax purposes, but not GST purposes.

Credit shelter [bypass] trusts, which are no longer necessary due to portability, are still required if one wishes to shelter the increased value of trust assets that occurs between first and second deaths.

The new law is silent on the subject of GRATs or grantor retained annuity trust. At first glance, GRATs would still apply as a legitimate estate planning tool. Also silent in the new law is the matter of discounts for lack-of-marketability and minority discounts; it would follow that reasonable discounts still apply.

Please consult your estate planner, attorney or CPA to determine how the law applies to your situation. If you have any question about valuation issues, please do not hesitate to call us.

DOL Proposes to Make Business Appraisers ERISA Fiduciaries

Since 1976, the U.S. Department of Labor has not held the independent appraisers who value the stock of employee stock ownership plans (ESOPS) to be fiduciaries. However, a proposed change to the Employee Retirement Income Security Act (ERISA) rules could reverse that policy. The proposal expands the ERISA definition of fiduciary to include those who give "investment advice," including as one example: "advice, appraisals or fairness opinions concerning the value of securities or other property."

The DOL believes that this change will cut down on purported abuses, such as incorrect valuations of the stock in private company-sponsored ESOPs, which can impact the participants' retirement savings. However, professional appraisal organizations are concerned that, in an effort to protect beneficiaries of pension plans, the proposed regulation will have a "chilling" effect on the market by exposing appraisers and other investment advisors to the increased risks of litigation. In addition, business appraisers who remain active in the market after any policy change would incur the extra expense of fiduciary liability insurance. Higher internal costs plus less competition among valuation firms doing private stock ESOP valuations might also translate into higher costs for the companies and more difficulty in finding competent work.

Industry groups such as the ESOP Association have already critiqued the proposed rule change. (See www.esopassociation.org/blog/template_permalink.asp?id=332#332.) The DOL held a public hearing in early March. For a copy of the proposal, originally published in the Federal Register, go to www.federalregister.gov/articles/2010/10/22/2010-26236/definition-of-the-term-fiduciary.

Amendments to FRCP 26 Re: Draft Expert Reports Could Contain Traps

The proposed amendments to Rule 26 of the Federal Rules of Civil Procedure (FRCP) became effective on December 1, 2010. These changes apply the privilege and work-product protections of Rules 26(3)(A) and (B) to expert-attorney communications and draft expert reports.

The revised rules could contain traps for the unwary, however. Litigants can still compel draft reports by a testifying expert if, for example, the drafts form any basis for the expert's opinion under the disclosure guidelines of Rule 26(a)(2)(B) of the FRCP. Moreover, the new rules apply only to the discovery of draft reports, not to their admissibility at the time of trial. Finally, there are still three attorney-expert communications that are open to discovery:

- Compensation for the expert's study or testimony;
- Facts or data provided by the lawyer that the expert considered in forming opinions; and
- Assumptions, if, any, provided to the expert by the lawyer that the expert relied upon in forming his opinion.

Appraisers and attorneys alike should wait to see how the new rules play out in practice. Experts, in particular, should continue to exercise good judgment. And of course, the new rule change applies only to matters in federal court. Professionals should keep an eye on local adoption and adaptation of the rules.

Divorce Courts Reject 'Calculation Values' Offered by BV Experts

During these tough economic times, parties and their attorneys may often request a business appraiser to perform a preliminary "calculation valuation" for settlement purposes. Although the majority of cases do settle, these two recent cases highlight problems of presenting anything less than a complete valuation in court.

In re Marriage of Hagar (Iowa App.)(Nov. 24, 2010). The husband and wife owned three dry cleaning stores, which they bought from his parents for $300,000 with a promissory note. Over the marriage, they paid down the note to nearly $121,000, but when the relationship deteriorated, the husband defaulted and his mother threatened forfeiture, so the wife borrowed money to pay the arrears. At trial, the court faulted the husband for wanting to "ruin the parties' financial picture," and valued the business at $95,000, or the midpoint in a range of $71,000 to $120,000 provided by the family's longtime CPA.

On appeal, the husband pointed out that the CPA actually testified that the business was worth between $71,000 and a *negative* $120,000. However, the wife pointed out that the CPA had offered his figures as a mere calculation of value, using "rules of thumb" and industry standards that didn't require the same professional judgment as a complete valuation.

The appellate court agreed that the CPA expressed his $120,000 value as a negative number. "However, we do not use [his] calculations because he admittedly did not '*use judgment*.'" The CPA also failed to recognize the family relationships that affected value. Based on the couple's purchase of the business for $300,000 and their creation of equity by paying the note down by $140,000, the appellate court valued the business at this higher amount and confirmed its award to the husband.

In re Marriage of Cantarella (Ca. App. 4 Dist.)(Jan. 11, 2011)(unpublished). In this case, the parties agreed to split the value of the marital business, which they said was worth $60,000, and the trial court adopted their agreement in its final orders.

Four months later, the wife returned to court with an attorney and a business appraiser, whose "preliminary valuation" indicated the business was worth $172,000. However, the appraiser admitted that he lacked the documentation with which he would typically perform a complete business valuation, including aged accounts receivable, payroll tax returns, equipment appraisals, etc. But the wife had traditionally handled all the business accounting, the husband argued, and withheld the documents to hide the business's debts and depressed accounts.

Based on this evidence, the trial court refused to reconsider its prior orders. At the same time, it *did* revise the value of the marital residence, based on a formal appraisal that the husband had withheld during discovery. The wife appealed the denial of her request to reconsider the value of the business, reasserting her appraiser's preliminary valuation. The appellate court rejected her claims, finding that—unlike the formal appraisal of the house—the calculation of value did not establish clear evidence of a mistake, and it confirmed the prior orders.

IRS Reveals Seven Mistakes of Highly Unsuccessful Appraisals

In recent conferences sponsored by business appraisal professional organizations and industry associations, the IRS has made an effort to discuss, on an informal basis, the most common reasons for auditing a business appraisal associated with a gift or estate tax return. Most of the following "red flags" will not surprise estate and gift tax attorneys (or their financial advisors) so much as confirm the areas that require continued professional oversight and appraisal expertise:

1. **Discounts.** The reasonableness of valuation discounts used in estate and gift tax appraisals is still a primary focus for the IRS, which will often flag discount conclusions that are not supported by the data or that apply study averages without sufficient explanation.
2. **Standard of value.** Likewise, the IRS is still seeing valuation reports that apply the fair value standard instead of fair market value, or consider the perspective of only one person (either the hypothetical willing buyer or the seller) rather than both.
3. **Tax-affecting.** Valuation of Sub-Chapter S corporations is another problematic area, in which the courts, valuation experts, and IRS examiners have not always been consistent. Rather than focus on the case law, attorneys and appraisers would be well-advised to carefully consider the particular facts and circumstances of any case. Related issues are tax considerations in C to S corporations and the valuation of embedded or Built-In capital gains tax liability.
4. **Factual errors.** Appraisal inaccuracies will also get the attention of the IRS. More than mere mathematical errors, these include presenting false information or assuming facts related to the appraisal that do not exist.
5. **Valuation errors.** Unfortunately, the IRS is still finding appraisals of business interests that purposefully include or exclude valuation approaches; ignore strong market evidence; or disregard professional standards. Many of these mistakes are made by individuals without the appropriate training or experience, and can be avoided by using qualified appraisers.
6. **Analytical errors.** The IRS is also finding appraisals that lack a strong, consistent factual development; an income stream that's inadequately or inappropriately matched to any adjustments (discounts); an incomplete tax rate analysis. Appraisals that supply a good "analytical fit" to the facts of a case clearly show how the valuation conclusions were reached; what adjustments were made; what data were used; and what law was relied on.
7. **Documentation errors.** Also watch out for: exhibits and computations that fail to follow the analytical narrative or are incomplete; and failure to document according to all relevant professional standards.

Choice of Reliable Growth Rate Is Key to Calculating Business Interruption Loss

***Manpower, Inc. v. Insurance Co. of Pennsylvania* (E.D. Wisc.)(Sept. 20, 2010)**

When its office building partially collapsed, the plaintiff shut down for 14 months until it could relocate. In a suit against its insurance company for business-interruption losses, the plaintiff's damages expert asserted over $7.5 million in lost profits and expenses. The defendant attacked the expert's calculations as unreliable under *Daubert*.

Growth rate nearly doubles under new management. The expert began by forecasting the revenues the plaintiff would have generated but for the collapse and

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then subtracted its actual revenues during the damage period. He then projected total, net, non-continuing expenses. So far, his calculations were "straightforward," the court said. However, the expert used the revenue period for five months preceding the collapse to extrapolate a 7.76% growth rate, despite historical data showing that the plaintiff had grown an average of only 4.8% during the four years prior to the collapse and only 3.8% during the year before. In support, the expert explained that the company had recently been acquired by new management to boost its performance. After speaking with the managers, the expert concluded they had turned the company around and thus the higher growth rate was appropriate for the entire 14-month loss period.

"Here is where [the expert's] analysis breaks down," the court said. The expert "did little more" than assume that the pre-collapse growth rate would continue unabated, all due to new management. He also failed to analyze other industry or company-specific factors that could have affected the plaintiff's revenues. Importantly, had the expert chosen a longer base period for his revenue forecasts, the court might have taken a different view. But by ignoring the plaintiff's historical track record, he essentially treated the company like a new business, a "notoriously difficult" exercise, the court said, which requires reliable financial indicators and comparables. Lacking these, it excluded the expert's opinions regarding lost revenues.

J.L. Pierson, ASA is an experienced business appraiser covering the tri-state area from a base in Darien, CT. His clients are closely held businesses with revenue of less than $200 million, as well as owners of FLPs. He specializes in valuation for estate/gift tax, succession planning, litigation such as shareholder disputes and divorce, corporate development, ESOP and other transaction support.

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