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J.L. PIERSON & Co. LLC
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<http://www.jlpierson.com>

Post Office Box 2392
Darien, Connecticut 06820-0392
Telephone/Fax: (203) 325-2703 • e-mail: jlpierson.com

IRS Finalizes New Adequate Disclosure Requirements for Valuations Filed with Gift Returns

The IRS' proposed Gift Tax Adequate Disclosure Rules were finalized on December 3, 1999 after much private and public discussion. The finalized regulations (Section 6501(c)(9)) set forth rules regarding the following issues: 1) a new statute of limitations period for adequately disclosed gifts, 2) a definition of what constitutes adequate disclosure and 3) very specific requirements for appraisals submitted to satisfy the adequate disclosure requirement.

The Treasury and the IRS maintain that the adequate disclosure rule was intended to enable the IRS to more efficiently identify the returns that should be examined. Pertinent sections of the new regulations are highlighted below.

Statute of Limitations for Revaluing Gifts. According to the final regulation, the new statute of limitation for assessment of gift tax is three years from the time the return is filed as long as adequate disclosure rules are met or satisfied. Before the Tax Reform Act of 1997 the IRS could revalue a gift at any time after the filing if the donor did not pay a gift tax for that particular gift (this circumstance would occur if the donor used a portion of their unified credit). In addition, the Tax Court held that a gift could be revalued for purposes of computing the decedent's estate. In other words, gift tax revaluation was open-ended at the Service's discretion, and could occur many years after a gift had been made.

Be aware that if the IRS challenges the valuation during the limitation period, the taxpayer's opportunity to contest it also ends with the limitation period. Thus, it is important to be aware of the limitation period and to take action swiftly if there is an indication that the IRS may challenge the appraisal.

(Continued on Page 2)

Using the services of an experienced and qualified business appraiser will decrease the likelihood of further examination by the Service

"Church vs. State" Victory for the Taxpayer

On January 18, 2000, the U.S. District Court for the Western District of Texas issued an opinion, resulting from a bench trial, in the first limited partnership case to be tried in federal court. The Plaintiff had asked for a refund of estate taxes they argued were wrongfully assessed and collected.

Timeline. On October 22, 1993, Elsie Church and her two children, Marshall Miller and Mary Elsie Newton, executed an agreement that resulted in the formation of Stumberg Ranch Partners Ltd. (the "Partnership" or "Stumberg") under Texas limited partnership law. On October

(Continued on Page 3, Column 2)

IN THIS ISSUE

IRS Finalizes New Adequate Disclosure Requirements for Valuations Filed with Gift Returns	1
"Church vs. State"	1

Adequate Disclosure of Transfers of Property Reported as Gifts - IRC Section 301.6501-1(f)(2).

Adequate disclosure, according to the finalized regulations, will be met if the taxpayer attaches to the return a statement that contains the following information (quoted from the final regulation, IRC Section 301.6501-1(f)(2)):

- (i) A description of the transferred property and any consideration received by the transferor.
- (ii) The identity of, and relationship between, the transferor and each transferee.
- (iii) The tax ID number and a brief description of the terms of any trust or a copy of the trust instrument.
- (iv) A detailed description of the method used to determine the fair market value of property transferred, including any financial data that was utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts claimed in valuing the property.

In the case of a transfer of an interest that is actively traded on an established exchange, such as the NYSE, the American Stock Exchange, the NASDAQ, or a regional exchange in which quotations are published on a daily basis, including recognized foreign exchanges, recitation of the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest quoted selling prices on the applicable valuation date will satisfy all of the requirements of this paragraph (f)(2)(iv).

In the case of the transfer of an interest in an entity (for example, a

corporation or partnership) that is not actively traded, a description must be provided of any discount claimed in valuing the interests in the entity or any assets owned by such entity. In addition, if the value of the entity or of the interests in the entity is properly determined based on the net value of the assets held by the entity, a statement must be provided regarding the fair market value of 100 percent of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity), the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the return. If 100 percent of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity.

If the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the information required in this paragraph (f)(2)(iv) must be provided for each entity if the information is relevant and material in determining the value of the interest.

- (v) A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer.

Submission of Appraisals in Lieu of Information Required under Paragraph 301.6501(f)(2)(iv). The requirements noted in item (iv) above can be cumbersome for the typical taxpayer. The good news is that the final regulations allow the attachment of a busi-

ness valuation report to satisfy item (iv). Following is a list of requirements for the appraisal and the appraiser (quoted from the final regulation, IRC Section 301.6501-1(f)(3)):

- (i) The appraisal is prepared by an appraiser who satisfies all of the following requirements:
 - (A) The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis.
 - (B) Because of an appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued.
 - (C) The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee, or any person employed by the donor, the donee, or a member of the family of either.
- (ii) The appraisal contains all of the following:
 - (A) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.
 - (B) A description of the property.
 - (C) A description of the appraisal process employed.
 - (D) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinion, and conclusions.

- (E) The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value.
- (F) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.
- (G) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.
- (H) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

Conclusion. The final regulations should be reviewed carefully by taxpayers and their advisors to determine the appropriate filing strategy for any gift transfer. Under these new rules, taxpayers have an added incentive to file adequate disclosure, especially on those gifts that are difficult to value in years when a portion of the unified credit is being used or an annual exclusion may precede a death. Using the services of an experienced and qualified business appraiser will decrease the likelihood of further examination by the Service. To discuss your needs for a high quality, credible appraisal or to discuss an appraisal issue in confidence, give us a call.

A copy of the final adequate disclosure regulations may be obtained on the internet at: www.access.gpo.gov/su_docs. ♦

“Church vs. State”

(Continued from Page 1)

24, 1993, Elsie Church died suddenly of cardiopulmonary collapse. Two days after Mrs. Church's death, October 26, 1993, the Certificate of Limited Partnership was filed with the Office of the Texas Secretary of State.

On July 25, 1994, the Estate of Elsie Church filed its return, valuing her limited partnership interest in Stumberg at \$617,000. The IRS served a notice of deficiency of \$212,000, plus interest. On April 8, 1996, the Estate paid a total of \$230,000. On June 26, 1997, the Estate filed a lawsuit seeking a refund of this payment after the IRS denied its claim earlier in the year.

Facts. Stumberg Ranch Partners Ltd. was formed for two purposes. First, the partners wanted to consolidate their undivided interests in a family ranch in order to centrally manage their holdings and preserve the ranch as an ongoing enterprise. Mrs. Church's two children actively managed the ranching operation. Second, Mrs. Church wanted to protect her assets against creditors in the event of a catastrophic tort claim against her. Mrs. Church and each of her children were limited partners. The general partner was designated as Stumberg Ranch L.C. which was to be owned by Marshall and Newton equally.

Capital contributions to the Partnership consisted of each limited partner's undivided interest in the ranch and \$1 million in marketable securities held by Mrs. Church in a Paine Webber account. The undisputed value of the interest in the Ranch contributed by Mrs. Church was \$380,000, while her children's interests were \$233,000.

The partnership agreement allocated profits or losses from the ranch operations in proportion to the interests

contributed by the partners. Ninety-nine percent of the taxable income from securities was allocated to Mrs. Church. Essentially, Stumberg was a pro rata partnership because profits, losses and income were allocated in proportion to each partner's capital contribution.

Arguments. At trial, the Service advanced several arguments in support of their denial of a refund of estate taxes. First of all, the Service argued that the partnership was not valid because the paperwork was not complete at the time of death and was formed in contemplation of Mrs. Church's death. The court disagreed because medical facts indicate there was no contemplation of death. In addition, the court cited the incomplete paperwork as an indication that no one involved had considered the potential for Mrs. Church's death.

The Service also argued that the partnership was formed solely to reduce Mrs. Church's taxable estate. The court disagreed and recognized that the partnership was formed for the two valid reasons noted above.

The Service suggested that the Partnership was simply a means of transferring property to family members for

(Continued on Page 4)

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less than full consideration. The government contended the difference between the fair market value of the assets Mrs. Church contributed to the Partnership, \$1.5 million, and the value of her Partnership interest, \$617,000, should be taxed as a gift. The court rejected this argument, indicating that Mrs. Church received a partnership interest proportional to the contributions and partnership interests of the other partners and there was no evidence that anyone experienced a financial benefit or increase in wealth.

The Service continued by claiming that securities held in the Paine Webber account had not been conveyed to the Partnership since only Mrs. Church's name appeared on the account several months after its formation; therefore, the estate should be taxed on its \$1 million value. The court disagreed, stating that well-established law directs judicial attention to intent of the parties, not legal title, when determining ownership of property.

Finally, the Service contended that the valuation of the partnership interest should not consider restrictions on

sale, which would reduce value, contained in the partnership agreement. The court rejected this indicating that there is nothing in the legislative history of the estate tax suggesting Congress wanted to address restrictions on sale/assignment of partnership interests. Rather

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Congress (Section 2703) indicated that rights and restrictions like below-market buy-sell agreements and options that artificially depress the fair market value of a taxable property should be disregarded because they are not inherent components of the property itself.

Opinion. Rejecting all the arguments put forth by the Service, the court granted the estate a full refund based on the value advanced by its business valuation expert. The govern-

ment did not present an alternate valuation opinion.

Conclusion. This case is interesting because the taxpayer scored a complete victory in that none of the government's arguments against the validity of the Partnership or the appropriate taxation of the Partnership interests were accepted. The facts of the case supported the conclusion that the Partnership was a valid entity. However, readers should be cautioned that judicial acceptance of this partnership does not mean any limited partnership will be accepted for estate tax purposes. That determination is very fact-specific.

It should also be noted that part of the reason this opinion might be characterized as a "taxpayer victory" resulted from the absence of a "battle of the experts". Many times, it seems that judicial opinions seem to "split the baby" when determining the value of a business interest between various expert opinions. The estate received its full prayer for relief in this case because the government offered no alternative valuation. ♦

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Darien, CT 06820-0392

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