Bill Would Have Far-Reaching Effect On Gift and Estate Tax Valuation

*by Jonathan Blattmachr, Esq., and Scott Nammacher**

Rep. Earl Pomeroy (D-N.D.) has introduced a bill (H.R. 436) that would have significant impact on the value of interests in real estate, investment holdings, and possibly operating entities for estate and gift tax purposes, echoing proposals made during the Clinton administration.

Certain aspects of the proposed bill seem to be difficult to discern, and further refinements and debate are surely going to come if it moves forward in committee. But, if enacted, it or similar bills likely will change the valuation of these kinds of "property" in many cases.

SOME FUNDAMENTAL VALUATION CONCEPTS

Valuation is an important factor in estate and gift taxation. The more property or assets are worth, the higher the tax, as a general rule.

Other than for directly owned publicly traded stocks and bonds, the estate and gift tax value of property interests held in a legal entity is usually determined by deciding at what price the property would change hands between a "willing buyer" and a "willing seller" — essentially, what the price would be if the interest was bought and sold by two unrelated parties (a "fair market value" level). That is the case, for example, for privately held business interests, real estate interests, and works of art.

The law currently provides that the nature of the property must be considered in determining its value. For example, an interest in an entity that does not represent control, where the owner cannot force its liquidation to obtain ownership of the underlying assets or to direct the entity's affairs, is worth less, and often far less, than an interest that does represent control of the enterprise.

Historically, prior to 1993, the Internal Revenue Service argued "family attribution" and attempted to aggregate all family interests. To the extent there was control at the family level, they disallowed any consideration for minority interests, assuming that families act in concert.

Over time, IRS lost a number of tax cases, and ultimately conceded the family attribution issue.[1] This allowed for transfers to occur at "fair market value" levels, rather than at very inflated prices with no discounts.

This bill is an attempt to legislate the earlier family attribution concept into law, in spite of the history of case law in direct contradiction to its reasonableness.

NO MINORITY DISCOUNT FOR "NON-BUSINESS" ASSETS

In essence, if an interest in a business controlled by a "family" unit were transferred, H.R. 436 would require that any "non-business" assets (stocks, bonds, excess cash, non-working capital, or land, etc.) be valued without any minority discount treatment. Such assets would be valued as if a proportionate interest in these assets were transferred directly by gift or at death.

The bill is unclear whether it is attempting to also preclude marketability discounts against these assets as well. This treatment would occur even though the estate, or person making the gift, does not control the entity and could not get to those assets if they wanted or needed to.

Who constitutes "family" includes a wide net of related parties, including different levels through marriages. Real estate owned by a partnership where a "family" controls, for example, will be treated as a passive asset unless the taxpayer "materially participates" in the operation of the real estate. Transfers by in-laws and step-descendants who might have small interests would appear to be treated as if they control — with taxes on values they could never realize in true third-party sales.

Although not expressly stated, the bill would treat assets such as publicly traded stock, bonds, cash, and similar portfolio-type investments held in a family investment partnership as though they had been transferred directly to the donees, rather than interests in a partnership being transferred.

Specifically, the bill would require the taxpayer to determine the passive assets of the entity (possibly all of them in a family investment partnership) and then value the transfer of the total interests as the sum of a proportionate share of the value of the passive assets

* Jonathan Blattmachr is a retired partner of Milbank, Tweed, Hadley & McCloy LLP in New York. Scott Nammacher is managing director of Empire Valuation Consultants LLC in New York.

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[1] *See*, e.g., *Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1999), and *Lee Est. v. Comr.*, 69 T.C. 860 (1978), *nonacq.*, 1980-2 C.B. 2; and Rev. Rul. 93-12, 1993-1 C.B. 202.

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(no minority discounts) plus the value of the "active business" interest in the entity (with applicable discounts).

It is unclear whether a lack of marketability discount would apply to the deemed passive assets.

Additionally, if a family-controlled business entity owns an interest of 10% or more (by vote or value) in another business and this business is deemed a "passive" asset, the same "look-through" rules apply — no minority discounts on the non-operating assets in that entity. This even applies to 10% interests owned by that second level of entity . . . and so on!

As indicated earlier, subject to exceptions, interests in family partnerships and businesses are worth less than the underlying assets the partnership owns because interests in family partnerships are worth little to third parties. Tax law has historically imposed estate or gift tax on property, in effect, only at the price a third party would pay for it. In effect, the bill would disregard the existence of an entity such as a family partnership, limited liability company (LLC), corporation, or other entity and treat any gift or bequest as being made of the assets owned by the entity, except for those actually used by the entity in the operation of a business.

POTENTIAL VALUATION IMPACT OF THE BILL

So how does this impact values? For example, in its purest form, assume two siblings, an aunt and nephew, or an individual and her stepgranddaughter's husband own a combined controlling interest (generally, more than 50%) of the stock in an active company (such as a car dealership, restaurant, or farm) but none owns more than 50% of the stock. The stock owned by either at death would be valued for estate tax purposes without regard to the fact that such a minority interest, in fact, is worth less than a proportionate part of the business valued as a whole.

This rule applies even if, on account of animosity or for many other reasons, the related owners would not dispose of their interests together. (In fact, if there were deemed to be excess assets in the business that were considered "passive," these might even be valued separately without discounts, even though the estate may not have any access to them.) This could impact values by anywhere from 5% to 25% or more depending on the specific facts and circumstances.

In essence, the tax to be applied in the estate valuation would actually have to be based on levels of value that are unrealizable in the real world, especially to anyone other than a single controlling shareholder with the power to liquidate or direct distributions. The value would be higher than any value the estate would likely be able to achieve upon selling the interest to third parties and, likely, even to insiders.

This would lead to a kind of "super tax" applied to entities deemed to be family-controlled, regardless whether these were the controlling persons or not.

These changes in valuation would be in effect for transfers after the date the bill is enacted. The bill would be applied on a prospective basis only to transfers after the date of enactment.

BILL WOULD EXTEND $3.5 MILLION EXEMPTION AND 45% RATE

The bill would make other changes that are similar to proposals others have made. It would extend the current $3.5 million estate tax exemption indefinitely.

The bad news for some taxpayers is that there would be an estate tax in 2010 — under current law, there is no estate tax for that year. The good news is that the $3.5 million exemption would stay in effect even after 2010, when the exemption was scheduled to be pared back to $1 million.

The bill would keep the current 45% tax rate in effect (it was scheduled to rise to 55% after 2010) but it would impose a type of limited surcharge for a taxable estate exceeding $10 million.

WHAT TAXPAYERS SHOULD DO

The bill, if enacted, would not necessarily mandate that taxpayers modify their basic estate planning documents, such as wills and revocable trusts. However, property owners who own interests in private entities, whether they are active businesses or management vehicles, probably should consult with their estate planning advisers to determine whether action should be taken before the bill becomes law or to determine whether overall estate planning (such as acquiring additional life insurance) should be changed.

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