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THROWING MAMA FROM THE TRAIN – A BANKER’S GUIDE TO ESTATE PLANNING THROUGH THE END OF THE DECADE

By David M. Repp
drepp@dickinsonlaw.com

I. ESTATE TAX: WHERE IT’S BEEN; WHERE IT IS; WHERE ITS GOING

Timing is everything. Congress and the President hailed the beginning of the end of the estate tax in the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). Under EGTRRA, the amount of assets that a person can convey to another at death without tax, dubbed the "unified credit amount," is currently \$2,000,000 and increases to \$3,500,000 in 2009. Then, in 2010, the party can really begin. The estate tax is repealed. *See Chart, below.*

In 2011, the party is over and the hangover begins. The estate tax is fully resurrected as if EGTRRA had never existed. The unified credit amount snaps back to \$1,000,000 (where it was scheduled to be prior to EGTRRA) and the highest marginal estate tax rate (currently 45%) jumps to 55 percent. This presents a rather uncomfortable situation for, say, an ailing mother who may know that if she dies on December 31, 2010, she leaves an entire estate to her heirs tax free, but if she survives to January 1, 2011, half of her estate is taxed away. EGTRRA created some interesting incentives for both taxpayers and their heirs.

Congress also added a few surprises affecting gifts. Under prior law, an individual could use up part or all of his or her unified credit amount during life in the form of gifts free of gift and estate taxes. That is the reason it is called a *unified* credit. Under EGTRRA, lifetime gifts in excess of \$1,000,000 are taxed. This is the case even during the year 2010 when the estate tax is repealed. Thus, during 2010, an individual can die and pass his or her assets to his or her heirs without tax, but cannot give his or her assets away while alive in 2010 without being taxed. Perhaps now the credit should be called the *un-unified* credit.

The repeal in 2010 may also be a double-edged sword to some. Under current law, most heirs of a decedent do not pay income tax on the increase in the value of the decedent’s assets as

of the date of death. In other words, assets generally are inherited “income tax free.” EGTRRA changes this in 2010. During 2010, heirs can only exclude up to \$1,300,000 of pre-death appreciation for income tax purposes. Spouses are allowed \$3,000,000. The troubling aspect of this rule, is that everyone now needs to keep track of the purchase price of all their assets so that if they die in 2010, their executor will be able to calculate how much appreciation has occurred in the asset and determine whether the \$1,300,000 or \$3,000,000 cap has been exceeded. Without such information, the purchase price is assumed to be \$0 and may cause heirs to incur some unnecessary income tax when they sell the property.

Why did Congress enact such an absurd law? The answer is in the budget. Congress needed to constrain the “cost” of estate tax repeal and other tax reductions to fit within its self-imposed \$1.35 trillion dollar cap. Since a temporary repeal costs less than a permanent one, EGTRRA was enacted with a “sunset” provision that takes effect in 2011. The hope was that some future Congress will eventually make the estate tax repeal permanent. That almost happened. On April 13, 2005, the House of Representatives voted 272-162 to finish off the estate tax by making the estate tax repeal permanent after 2010. The Republican controlled Senate came within three votes of a complete repeal. With Democrats controlling the House and Senate following the 2006 election, a subsequent vote on the repeal of the estate tax is unlikely.

With 2011 looming, estate tax planning needs to be started now. Two estate planning tactics for high net worth individuals are discussed next.

II. VALUATION DISCOUNTS

A discount can apply to the value of bank stock gifted to descendants during life or bequeathed after death for federal estate and gift tax purposes. Such discount can be significant, ranging from 30% to 60% from its undiscounted value. Following are some factors that will affect whether a discount applies and the amount of the discount:

1. Minority Discount

Courts have long recognized that the shares of stock of a corporation which represent a minority interest are usually worth less than a proportionate share of the value of the assets of the corporation.¹ The theory of the minority interest discount is that the owner of less than a majority interest in an enterprise cannot, alone, control day-to-day or long-range managerial decisions, affect future earnings, control efforts for growth potential, establish executive

¹ *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981); *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990); *Ward v. Commissioner*, 87 T.C. 78 (1986); *Cravens v. Welch*, 10 F.Supp. 94 (Cal. 1935).

compensation, or compel a liquidation to reach the corporate assets. Because the owner of a minority interest lacks these benefits of control over the business, an acquirer of such an interest will pay less for it, on a pro rata basis, than for a controlling interest. Where the holder lacks the ability to exercise control over the operations of the enterprise, his or her interest may be worth significantly less than its "liquidation" value.

2. Marketability Discount

The lack of marketability discount is based on the fact that stock in a closely held business enterprise is less attractive and more difficult to sell than publicly traded stock. Where an active trading market does not exist, other factors may be used as valuation benchmarks, and the lack of marketability discount becomes operative and applicable. Lack of marketability discounts relate to the inherent lack of flexibility in getting in and out of investments with no ready market.²

Unlike the discount for lack of control (the minority interest discount), the marketability discount can be applied in cases of gifts of more than 50 percent. In the *Estate of Wildman*,³ the Tax Court granted a ten percent discount on the decedent's interest in farm land partially for the reason that the farms were not contiguous properties. The court is essentially applying a marketability discount for the reason that contiguous farms are more marketable than small, noncontiguous farms.⁴ Clearly, this type of marketability argument would exist regardless of the size of the interest gifted. Appendix A, located at the end of this Outline, includes a list of Tax Court cases where a sizeable marketability discount was granted to the taxpayer for transfers of controlling interests.

3. Discount for Built-in Gain

Until recently the Tax Court was ambivalent about allowing a discount for unrecognized capital gains in the assets of a C corporation. An example of unrecognized built in gains is farmland owned by a corporation with a basis \$1,000 an acre and a fair market value of \$6,000 an acre. \$5,000 an acre would be the unrecognized, built-in, capital gain. The Tax Court and Court of Appeals have allowed a discount for built-in capital gains in recent cases: *Estate of*

³ 1989 T.C. Memo 667.

⁴ See also *Estate of Murphy*, 1990 T.C. Memo 472 (allowing discount for marketability for decedent constructively owning 51 percent of stock).

Davis, 110 T.C. 530 (1998); *Eisenberg v. Comm.*, 155 F.3d 50 (2nd Cir. 1998). The Internal Revenue Service acquiesced. See Internal Revenue Bulletin 1999-4, 4.

An issue that was, until now, unresolved was how much of a discount can be taken for built-in capital gains. In *Estate of Jelke et al v. Commissioner*, 05-15549, US Court of Appeals for the 11th Circuit, November 15, 2007, the Eleventh Circuit overturned the Tax Court and allowed the estate a dollar-for-dollar reduction in fair market value for the hypothetical tax on trapped-in gains for a “C” corporation minority shareholder. The court cited *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002) which it said “has the virtue of simplicity and its methodology provides a practical and theoretically sound foundation as to how to address the discount issue... This 100% approach settles the issue as a matter of law, and provides certainty that is typically missing in the valuation arena. We thereby follow the rationale of the Fifth Circuit in the *Estate of Dunn*, that allows a dollar-for-dollar, \$51 million discount for contingent capital gains taxes...”

A built-in gain discount is not available for LLCs taxed as partnerships. In *Jones v. Commissioner*, 116 T.C. No. 11 (2001), the Tax Court did not allow a built-in capital gains discount for an asset in an LLC taxed as a partnership for the reason that a partnership can make a Code Section 754 election which allows a partnership to raise the basis of its assets to match the purchase price of the partnership interest.

4. Recent Cases

Green v. Commissioner

Decedent, Mildred Green, died in 1997 owning 3,276 shares (5.09%) of Royal Bancshares, Inc. (RBI), a Missouri one-bank holding company. No one person held a controlling interest in the stock and the largest shareholder owned 14.38 percent of the common stock. As of the date of value, the bank was financially healthy although it had a \$1.6 million loan in default.

RBI’s book value was \$17,369,000 and was valued at 1.51 times book value, or \$26,266,667, the equivalent of \$408 per share. The estate reported a value of \$50 per share on the tax return. The IRS challenged the valuation of the RBI shares. On audit, the IRS asserted a value of \$320 per share for RBI.

The estate’s expert determined a 17% minority discount and a 40% discount for lack of marketability. The IRS expert determined a 15% minority discount and a 25% discount for lack of marketability. The Tax Court found the IRS’s expert’s analysis for minority discount flawed.

The Court also thought the taxpayer expert had not adequately supported his 17% minority discount, but ultimately did accept it.

For the discount for lack of marketability, both experts relied on the restricted stock studies while the taxpayer expert relied on pre-IPO studies as well. The taxpayer expert arrived at his 40% discount comparing the studies to various factors relating to RBI, including a large impaired loan and prior sales of RBI shares. The Court found the expert had incomplete knowledge of the impaired loan. The Court was further concerned that the prior transactions may not have been at arm's length and a number of the transactions were more than 3 years old.

The IRS expert relied heavily on study prepared by Management Planning, Inc. The Tax Court found fault with the manner in which the study was applied. Ultimately, the Court decided on a 35% discount for lack of marketability.

The court first applied the 17% minority discount to the undiscounted value of \$408 per share, and then applied the 35% marketability discount, arriving at a value of \$220 per share. This equates to a combined, melded discount rate of 46%.

Kelly v. Commissioner

In *Estate of Webster E. Kelley v. Commissioner*²⁶ the Tax Court allowed a combined 32.2% discount for a family limited partnership consisting entirely of cash and cash equivalents. Thus, in addition to claiming a valuation discount for bank stock, other assets, such as cash and marketable securities, may qualify for a discount if such assets are properly contributed to a family limited partnership or family limited liability company.

The facts of the case are as follows: The decedent, his daughter Patricia Loudon and son-in-law John Loudon, organized Kellen-Louden Business Properties, LLC (KLBP, LLC), and Kellev-Louden, Ltd., a Texas limited partnership (KLLP). Decedent contributed \$1,101,475 in cash and certificates of deposit to KLLP between June 6, 1999, and September 11, 1999. On September 13, 1999, the Louden's contributed \$50,000 cash to KLLP. Mr. Kelley died on December 8, 1999, owning a 94.83% equity interest in KLLP and a 33.33% equity interest in KLBP, LLC. The sole asset of KI,BP, LLC was a 1% equity interest in KLLP. On the date of death, KLLP held assets totaling \$1,226,421 (consisting of \$807,271 in cash and \$419,150 in certificates of deposit). KLLP had no liabilities. The Estate return reported that decedent's 94.83% equity interest was valued at \$521,565 and his interest in KLBP, LLC was valued at \$1,833.33. The discount used by the Estate totaled approximately 53.5% for both equity

²⁶ T.C. Memo 2005-235.

interests (consisting of a minority interest discount of 25% and marketability discount of 38%). The IRS issued a notice of deficiency stating that the discounts claimed by the estate were too high and lower discounts were appropriate. The IRS indicated that a total discount of 25.2% was more appropriate (12% for minority interest and 15% lack of marketability) for both equity interests.

Estate's Argument. The Estate's appraiser relied 80% on a net asset value approach and 20% on an income approach. He then applied a discount for lack of control based on general equity closed-end mutual funds. He divided the closed end funds into four quartiles (the first quartile representing funds high in demand and the fourth quartile representing funds low in demand). The Estate's appraiser determined that the fourth quartile was most comparable after reviewing several factors of KLLP and KLBP, LLC including small size, no professional management, less diversification and lack of performance history. The discount range for the fourth quartile was 21.8 to 25.5%. He also then further adjusted the discount based on several factors and restrictions inherent in the partnership agreements and through reliance on a partnership study published by Partnership Profiles, Inc.—ultimately determining a minority interest discount of 25%. The Estate's appraiser based his discount for lack of marketability on restricted stock studies. He also discussed eight (8) factors that provided barriers to marketability for limited partnership interests and determined a 38% discount for lack of marketability was appropriate.

IRS's Argument. The IRS's appraiser solely used the net asset value approach. He applied a discount for lack of control of 12% which was determined using an arithmetic mean of the entire data set for closed-end funds (not only the fourth quartile). He stated that it is essential to use the whole array of closed-end funds as this calculation removed the marketability element contained in the discount. The IRS's appraiser based his discount for lack of marketability on a private placement study by Dr. Mukesh Bajaj. This study states that private placements of unregistered shares trade at a discount of about 14.09% higher than the average discount on registered placements. Accordingly, he determined that a discount for lack of marketability of 15% was appropriate based on the low risk of the partnership's portfolio.

The Tax Court's Ruling – 12% Minority Discount and 23% Marketability Discount. The Court indicated that the net asset value method is generally an appropriate method to apply when computing the value of a nonoperating entity. Both parties agreed on the asset values and the Court agreed that KLLP's net asset value on the valuation date was \$1,226,421 (consisting of \$806,271 in cash and \$419,150 in certificates of deposit).

Regarding the discount for lack of control (or minority interest discount), the Court was not persuaded by the Estate appraiser's use of the fourth quartile of closed-end funds or the analysis of the Partnership Profiles partnership study. The Court indicated that they felt that these studies contained some element of a marketability, discount and were thus overstating the minority interest discount. The Court agreed that a correct analysis is to take an arithmetic mean of all of the closed-end funds. The Court also stated that "they find neither expert particularly persuasive on this issue, but will apply a 12% discount on the grounds that (1) the IRS's appraiser has effectively conceded that a discount factor of 12% would be appropriate and (2) the Estate's appraiser has failed to prove that a figure greater than 12% would be appropriate."

Regarding the discount for lack of marketability, the Court was not persuaded by the Estate appraisers' use of restricted stock studies as this study primarily referred to operating companies and not investment companies. However, the Court was also not persuaded by the IRS appraisers' recommendation of a 15% marketability discount. The Court agreed that the Bajaj study was an appropriate tool for determining the discount for lack of control, but stated that the IRS appraiser did not properly apply the study. The Bajaj study divided the discount into three groups with the middle group having a discount of 20.36%. The Court relied on *McCord v. Commissioner* (120 T.C. No. 13), which used this middle group and rounded it to 20%. The Court further cited the analysis of marketability in *Lappo v. Commissioner* (T.C. Memo 2003-258) in which an additional 3% marketability discount was allowed because of characteristics specific to the partnership. Thus, the Court determined a total discount for lack of marketability of 23%.

The Court allowed the same discounts for the decedent's 33.33% equity interest in KLBP, LLC as this entity only owned a 1% equity interest in KLLP.

Kelley was a great victory for taxpayers although the IRS considers it an anomaly.²⁷ The Court ultimately determined a combined discount of 32.2% on a partnership that contained cash and certificates of deposit. It also appears that if the Estate's appraiser had a better argument for more than a 12% minority interest discount the Court may have granted it. The Court thought that a private placement study by Bajaj was more appropriate than restricted stock studies for the marketability discount determination.

²⁷ See Appeals Coordinated Issue Settlement Guidelines issued by the IRS on October 18, 2006 (effective October 20, 2006).

III. GRANTOR RETAINED ANNUITY TRUSTS

Today's low interest rates create an estate planning opportunity using grantor retained annuity trusts.

A grantor retained annuity trust (GRAT) is a method of "freezing" the value of the grantor's estate by giving remainder interests in certain property, such as bank stock, to family members or loved ones and retaining an income interest (either all the income from the property, an annuity amount or a unitrust amount) for a period of years. When the trust is established, a gift of the remainder is made to the beneficiaries and a gift tax return must be filed. When properly structured, the value of the gift is equal to the actuarial value of the remainder interest.

The only drawback to this estate freeze method is that the grantor must outlive the term of the trust. Otherwise, the value of the trust assets are included in the grantor's estate. Thus, a dilemma for the grantor is created in determining the proper length of the trust. The grantor should want the trust term to be as long as possible, because the longer the trust term, the smaller the remainder interest and thus, the smaller the taxable gift. Alternatively, the grantor must outlive the trust or the entire estate planning scheme is all for not. A form of grantor retained annuity trust is included at the end of these materials.

GRATS should be funded with assets that preferably are high yielding and have a high basis. The size of the gift that is deemed made by the creation of a GRAT is a direct result of the interest rate that is used in valuing the retained annuity. The annuity is valued using Table H of the Internal Revenue Service valuation tables that can be found in I.R.S. Publication 1457. Within Table H, the appropriate table to use depends on the interest rate in effect under Code Section 7520 for the month the trust is created. For May, 2008, the rate is 3.2 percent. A GRAT is effective to transfer wealth to a second generation at less than the normal gift or estate tax rates only if the trust assets produce at a rate higher than the Section 7520 rate in effect at the creation of the trust.

If the trust assets of a GRAT grow at a rate higher than the applicable Section 7520 rate, the remainder interest will be undervalued when the trust was created--that is, the present value of the remainder interest for gift tax purposes will be \$X, and the present value of the property the younger generation actually receive when the trust terminates will be greater than \$X. The greater the rate by which the trust assets outperform the applicable Section 7520 rate, the greater the value of the property that will be transferred to the younger generation free of transfer tax.

CAUTION: The opposite holds true if the trust assets do not perform to the same level as the applicable Section 7520 rate. In such case, the grantor essentially pays gift tax (or uses up unified credit) on property that is never transferred to the second generation.

GRATS should also, preferably, be funded with assets that have a high basis. If the grantor survives the term of the trust, the basis of the assets in the hands of the grantor will be the basis in the hands of the children. Therefore, if the children sell the property after the trust terminates, they will have to pay income tax on any appreciation in the value of the property over the original basis. This would not be the case if the grantor died with the property and if the property's basis were stepped up to its fair market value. However, for wealthy grantors, it is better in most cases to have the children pay income tax on the appreciation of the property than subject the property to high estate tax.

Other considerations and planning aspects of using GRATS include:

- * Factor in a minority discount if the trust property is a family business or is otherwise nonpartitionable. A minority discount, as discussed *infra*, can only be used if a beneficiary receives an asset worth less than the proportionate share of the whole asset. This is commonly the case when less than a majority share of a business is transferred to another individual. It will also work occasionally for interests in real estate that is difficult or costly to partition.
- * Purchase insurance on the grantor's life during the term of the trust. One way to protect against the risk that the grantor will die prior to the term of the GRAT is to purchase insurance in a sufficient quantity that will cover the amount of additional estate tax due on the GRAT assets included in the grantor's estate.
- * If a question exists as to the likelihood of a grantor surviving the term of a GRAT, an alternative may be to reduce the GRAT term to a short period such as two years and increase the size of the annuity payout. Two years is probably the shortest possible term of a GRAT. Each annuity payment can then be rolled over into successive GRATs with similar terms.

Illustration

The table below illustrates how a GRAT may pass wealth on to descendants without paying a gift tax. At the current hurdle rate of 3.2%, for May, 2008, the grantor would need to choose an annuity payment of about \$1.2 million and a term of 10 years to avoid paying a gift tax on a \$10 million GRAT. Assuming, for simplicity's sake, that the assets within the GRAT return 5% each year (actual returns, of course, will vary from year to year), the tax-free gift when

the trust expires in 10 years would be \$1.4 million. With each additional 1% of return, the remainder value in the GRAT would increase; if returns approach 9%, \$5.7 million would pass free of tax to the heirs.

<i>Initial GRAT Structure</i>		<i>Resulting IRS Gift Tax Assessment (at current IRS rate – 3.2%)</i>	
Contribution	\$10 Mil	Present Value of Annuity	\$10 Mil
Chosen Annuity Payment	\$1.2 Mil	Expected GRAT Remainder at End of Term	\$0
Chosen Term of GRAT	10 Years	Resultant Gift Tax	\$0

If the annual return on the trust assets is . . .	The tax-free gift would be . . .
5%	\$1.4 Mil
6%	2.3
7%	3.3
8%	4.4
9%	5.7

Appendix A

Marketability Discount Cases for Transfers
of Controlling Interests

Name of Case	Size of the Interest Valued	Amount of Marketability Discount	Amount of Minority Discount	Type of Business of Corporation	Comments
Estate of Gregg Maxcy 28 T.C.M. 783 (1969)	95%	15%	0%	Ownership of Citrus Groves, Mortgages and Accounts Receivables	"Due to the nature of the various assets, there was relatively small market for prospective purchasers . . ." "Also the corp.'s shares were less desirable than its underlying assets, because a potential purchaser of its shares faced the possibility of contingent, or hidden corporate liabilities."
Estate of Murphy 60 T.C.M. 645 (1990)	51%	20%	0%	Radio and T.V. Broadcasting Stations	". . . it should be borne in mind that even controlling shares in a nonpublic corporation suffer from lack of marketability because of the absence of a ready private placement market and the fact that floatation costs would have to be incurred if the corporation were to publicly offer its stock."
Estate of Bennett 65 T.C.M. 1816 (1993)	100%	15%	0%	Real Estate Development Corporation	"Here we have a real estate management company whose assets are varied and nonliquid. We think that the corporate form is a quite important consideration here: there is a definitely a difference in owning the assets and liabilities of [the corporation] directly and in owning the stock of [the corporation], albeit 100 percent of the stock."

Name of Case	Size of the Interest Valued	Amount of Marketability Discount	Amount of Minority Discount	Type of Business of Corporation	Comments
Estate of Luton 68 T.C.M. 1044 (1994)	78%	20%	0%	Cattle Ranch	"The lack of marketability discount is designed to reflect the fact that there is no ready market for shares in a closely held corporation. This principle has been applied to controlling as well as minority shares." ⁵
Gray v. Commissioner T.C. Memo 1997-67	82.49%	15%	0%	No business was conducted. Corporation held investment assets.	"A controlling interest in a nonpublic corporation may be unmarketable. Respondent offers no authority that a marketability discount does not apply when valuing a controlling interest. Respondent contends that a discount for lack of marketability applies only to property valued by using comparable sales or freely traded value and not by reference to net asset value. We disagree. Marketability discounts may apply to companies that were valued using the net asset value method."
Estate of Hendrickson T.C. Memo 1999-278	49.97% (effective control)	30%	0%	Bank	"Even controlling shares in a nonpublic corporation can suffer from lack of marketability, because of the absence of a ready private placement market and the costs of floating a public offering."
Estate of Maggos T.C. Memo 2000-129	56.7%	25%	0%	Pepsi-Cola Bottling Company	"After carefully considering all the relevant evidence, including the expert reports and testimony, we consider an illiquidity discount of 25 percent to be appropriate."

⁵ "... But this Court has found that a discount for lack of marketability is not warranted where a decedent owned all of the stock of a company whose assets consisted solely of cash and marketable securities (liquid assets)." Estate of Jephson v. Commissioner [Dec. 43,245], 87 T.C. 297 (1986). "The discount should reflect that restrictions are placed on the land as a result of the Williamson Act and that the assets of the corporation are not liquid." The Williamson Act places certain use and development restrictions on the property for ten years.

Name of Case	Size of the Interest Valued	Amount of Marketability Discount	Amount of Minority Discount	Type of Business of Corporation	Comments
Estate of Jones 116 T.C. no. 11 (2001)	83.08%	8%	0%	Cattle Ranch	“A marketability discount would apply, but we believe that, under the circumstances of this case, an 8 percent discount more accurately reflects reality.”
Estate of True T.C. Memo 2001-167	68.47	20%	0%	Oil and Gas Business	“Thus, if the interest being valued had the power to liquidate the corporation, then demand for the corporation’s assets (rather than its stock) and existence of a market for such assets are most relevant to our analysis of marketability.”