



Hot Topics in Estate Planning & Valuation

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Discussion Topics

- Recent Developments & Buzz
- Planning & Valuation Considerations for Digital Assets / Crypto
- Recent USTC decisions
 - Cecil vs. U.S.
 - Latest case addressing (1) tax affecting - whether the value of a pass-through entity that engages in an active trade or business should be valued based on entity income or tax-affected earnings and (2) whether an earnings-based or asset-based value is appropriate for an asset-intensive operating business.
 - Connelly vs. U.S.
 - Impact of Corporate-Owned Life Insurance on Decedent's Equity Stake
- Latest Observations from IRS Audits
 - Tax Affecting Debate, Valuation Discounts, Recent Settlements, Managing an IRS Audit Response Process
- IRS CCA 202152018
 - Should the hypothetical buyer/seller of stock in a closely held corporation consider a potential/pending merger for purposes of valuing stock for gift tax purposes? Answer: YES!
 - Did the Donor retain a qualified annuity interest in Trust when the Donor used an outdated appraisal that did not consider the potential/pending merger? Answer: NO!
- Recent IRS Statements on Carried Interest

About MPI

- MPI is a national consulting firm founded in 1939, specializing in business valuations, litigation support and corporate advisory work. We have delivered thousands of financial opinions to business owners, attorneys, accountants, wealth advisors and other fiduciaries across a wide variety of industries.
- Our sweet spot has traditionally been closely held or family-owned companies in the small and middle markets, but our clients range in size from several million-dollar revenue businesses to multi-billion-dollar global enterprises.
- We are known and trusted by our long-time clients and their advisors on their most sensitive financial and tax matters.
- MPI clients can be assured that they will receive high quality service, a comprehensive, professional and persuasive work product, and the benefit of decades of collective experience and institutional knowledge.
- MPI has offices in Chicago, New York, Philadelphia, Princeton (the corporate headquarters), San Francisco, Seattle, and Westport.

Diversified Valuation & Advisory Services

Business Appraisals

- Estate, Gift, Income Tax Valuations
- Restricted Stock / Blockage Studies / Discount Studies
- Corporate Planning / ESOP Valuations / Buy-Sell Agreements

Litigation Services

- Commercial Litigation / Damages / Fraud Investigations
- Matrimonial Litigation / Asset Tracing
- Shareholder Disputes / Contract Disputes / Forensic Accounting

Corporate Advisory + M&A

- Evaluation of Strategic Alternatives / Sale-Merger Valuations
- Buy-Side + Sell-Side M&A
- Fairness Opinions

Financial Reporting

- Purchase Price Allocations / Goodwill Impairment Testing
- Equity-Based Incentive Compensation
- Portfolio Company Valuations / Intangible Asset Valuations

Experience & Capabilities

What types of assets do we value? (pg. 1 of 2)

- Closely Held Operating Companies / Family Businesses
- Partnerships & LLCs: Real Estate / Liquid Assets / Artwork / Exotic Cars
- Fractional Interests in Real Estate / Artwork
- Preferred Freeze Partnerships
- Intrafamily Notes
- Vertical Slice Planning for Principals of Hedge Funds, Private Equity and Venture Firms
- Derivative Contracts on Carried Interest, Other Assets
- Pre-IPO Stock
- Large Blocks of Publicly Traded Stock / Restricted Stock

Experience & Capabilities

What types of assets do we value? (pg. 2 of 2)

- Options and Derivative Instruments
- Charitable Gifts of Private Investment Fund Interests, Highly Appreciated Assets, Bitcoin, Other
- Cryptocurrencies & Blockchain Companies
- Remainder & Income Interests in Trusts
- Guarantee Fees
- Start-Up / Early Stage Company Stock
- Royalty interests (music, books, plays, etc.)
- Litigation Claims
- Rollover Equity from M&A Deal

What Drives the Valuation Need?

- Estate Tax (706) Filing; Gift Tax (709) Filing
- Intrafamily Sales / Sales to Trusts / Asset Swaps
- Tax Controversy / IRS Audit Consulting
- Expert Witness Testimony
- Charitable Giving / Charitable Deductions
- Buy-Sell Triggering Events
- Partner Buy-Ins, Buy-outs, Equity Grants
- Establishing Preferred Freeze Partnerships
- Forgiveness of Notes, Interests in Trusts
- Marital Dissolution / Pre-Nuptial Agreements
- Shareholder Disputes / Divorce / Buyouts
- Exit Tax (Expatriation)
- FIRPTA Tax

Industries & Geographies

- MPI has experience across all major industries and with hundreds of industry niches
- MPI's analytical staff has a breadth of industry experience, including analysts with specific industry concentrations
- Most assets valued are domiciled in the U.S., but experience includes assets in Canada, Mexico, the Caribbean, the UK, Mainland Europe & Asia

Industries / Specialties

- Real Estate
- Professional Sports Franchises
- RIAs / Hedge Funds / Private Equity / VC
- Carried Interest Planning
- Healthcare / Biotech / Pharma
- Construction
- Manufacturing & Distribution
- Auto Dealerships
- Food & Beverage, Beer & Wine



Recent Developments & Buzz



Recent Developments & Buzz

- IRS gets \$80B appropriated over 10 years; hiring 87,000 employees?
 - The IRS had planned to hire 5,500 individuals for tax year 2022, but only hired 3,400.
 - Uncertainty remains, but expect audit rates to increase over the next ten years.
- Sunsetting of the higher exclusion amounts on 1/1/26
 - This will occur UNLESS there is action taken by Congress to extend, modify, replace, etc. Can Congress get anything done?
 - Block your calendars for December 2025?
- Proposals to alter grantor trust rules: (1) making transactions with the grantor taxable; and (2) treating the income tax paid by the grantor as a gift.
- Private foundations making distributions to DAFs to satisfy the 5% required minimum annual distribution.
 - Proposal to make this a “non-qualifying distribution”.
- Anti-clawback regulations are good, but if your transaction fails IRC 2036, you have two problems.
- How do we get clients to move and not wait until 2025?
 - Values in many sectors are down significantly; could be a very good time to do planning in 2023.
 - Banks & Trusts will run out of room at end of 2025; don't want to risk being shut out.
 - Inflation adjustments mean clients that thought they used all their exclusion suddenly have much more to use.

Recent Developments & Buzz

- Continue to see proposals to alter GRAT rules.
- IRS increasingly auditing GRATs; taking hard line on operational issues
 - Do the terms comply with 2702?
 - Has the GRAT been operated in accordance with its terms?
 - Have the assets contributed to the GRAT been valued properly and in good faith?
 - Stale appraisals or poor-quality appraisals could lead IRS to conclude that the grantor's retained interest is not a qualified annuity interest (see CCA material later herein).
 - Is a consistent valuation method being used for the initial valuation, for in-kind annuity payments and for substitutions?
 - Have annuity payments been made timely? 105-day window

Recent Developments & Buzz

- IRS Statement on Carried Interest Valuation
 - Many taxpayers own “carried interest” or “promote” as a result of working for a private equity firm, hedge fund sponsor, venture capital firm, or real estate manager.
 - These interests are often “granted” or “issued” on or about the date the fund launches or has a final closing. Due to Rev. Proc. 93-27 & Rev. Proc. 2001-43, the receipt of these “profits interest” are not a taxable event for income tax purposes.
 - A core “play” in the “estate planning playbook” for these taxpayers is to transfer the carry into a trust at the inception of the fund.
 - Some taxpayers and tax advisors have argued that these revenue procedures mean that a profits interest has zero fair market value at issuance, making it the perfect estate planning asset.
 - Clifford Warren of the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries) spoke at the USC Gould School of Law Tax Institute in early 2022:
 - “One thing that is crystal clear is that [Rev. Proc. 93-27] is not applicable generally to valuing carried interest...On the day you get that carry, even though you have zero right to proceeds...that thing is going to be worth tens of millions of dollars today, potentially...No, you’re not taxed under income tax at that point. But if you were to gift that carry and claim it has a zero fair market value under the revenue procedure, that’s a fight we would love to take.”

Digital Assets / Crypto

Developing Crypto Issues

- What/where are we seeing Crypto in our practice?
 - Charitable Giving / Estate Tax Filing / Intrafamily Gifts / Financial Reporting (GAAP Compliance)
- What are the issues that valuation firms are faced with in appraising crypto?
 - Determining the type of cryptocurrency to be appraised.
 - Payment Cryptocurrencies (e.g., Bitcoin) / Utility Tokens (e.g., Ether) / Stablecoins (e.g., USDC, USDT) / Central Bank Digital Currencies (“CBDCs”)
 - Assessing the data sources available; how to satisfy traditional valuation/pricing concepts?
 - Determining if there are restrictions on the ability to sell.
 - Assess block size; considering blockage discounts.
 - Ensuring that the completed appraisal meets IRS guidelines.

Applicable Guidance & Regulations

- IRS Notice 2014-21 – IRS Virtual Currency Guidance
- IRS Pub. 561 – Determining the Value of Donated Property
- IRS Section 1.170A-13
 - Recordkeeping & Requirements for Deductions of Charitable Contributions
- IRS Bulletin 2006-46, Notice 2006-96
 - Guidance Regarding Appraisal Requirements for Noncash Charitable Contributions
- CCA Memo #202302012 (1/10/23)
 - Qualified Appraisal Requirement for charitable contributions of crypto
- CCA Memo #202302011 (1/10/23)
 - Deductibility of cryptocurrency losses

Representative Experience

- Charitable gifting
 - Contributions of Bitcoin, Ethereum, etc. to donor-advised funds.
- Estate tax reporting
 - Cryptocurrency wallets in the decedent's estate, whether previously known or discovered during estate administration.
- Generational gifting
 - Cryptocurrencies among the assets in a traditional securities FLP
 - Private investment funds that own cryptocurrencies
 - SAFT: Simple Agreement for Future Tokens
 - An "SEC-Friendly" way to conduct an ICO.
 - STO – Security Token Offering
 - Equity-based tokens that are compliant with KYC/AML.
 - Promissory notes for tokens that gradually unlock via smart contracts every few seconds for the term of the note.
 - Operating companies, including cryptocurrency exchanges and other enabling infrastructure, private equity sponsors and crypto-focused hedge funds.
- Financial Reporting
 - Appraisals of token positions (including lock-up discounts) under ASC Topic 820 – Fair Value Measurement

Charitable Gifts – Information & Requirements

- Although cryptocurrencies are priced on exchanges, a Qualified Appraisal is required under Section 170(f)(11)(C) to qualify for a deduction under section 170(a).
 - IRS Notice 2014-21 states for federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.
 - The IRS has now adopted the term “Digital Assets” in place of “virtual currency”.
 - Chief Counsel Advice Memo 202302012 (published January 2023) clarifies and reminds taxpayers of the need for a qualified appraisal for cryptocurrencies.
- Donors eliminate the significant capital gains taxes on the appreciation.
 - This makes cryptocurrencies an ideal asset to contribute to donor-advised funds.
 - It is likely that these donations would be liquidated in an orderly manner by the sponsoring organization.
- According to studies prepared by Fidelity Charitable:
 - 45% of cryptocurrency investors donated \$1,000 or more to charity in 2020, vs. 33% of the general investing population.
 - 55% of cryptocurrency investors are not aware that cryptocurrency assets can be donated to charity.
 - 2/3 of donors were driven by a desire for social good.



Notable Tax Court Decisions

USTC & Federal District Court

- Jones, Kress, Jackson, Cecil – all addressed the issue of valuing pass-through entities and where the pass-through income tax is relevant to the valuation of the equity.
- Grieve – Court rejected a common IRS argument that a large non-controlling owner could buyout the 1% controlling owner at a significant premium, thus warranting very little discount on the large non-controlling interest. 35% discount upheld on a 99.8% non-controlling interest.
- Nelson – Tiered discounts were accepted; 59% overall effective discount applied. Involved a family investment company that owned interests in numerous underlying operating businesses.
- Warne – For estate tax purposes, controlling, majority interests in five LLCs were valued at an 8.8% discount to NAV. While 100% of the equity of two LLCs were left to charity, a charitable deduction equaling the value of 100% of the entity was disallowed. Since what passed were two slices of the equity to separate charities, discounts were applicable to each interest that was donated (a 27.4% discount was applied to the 25% interest donated; a 4% discount was applied to the 75% interest donated).

USTC & Federal District Court

- Connelly – proceeds of corporate-owned life insurance is includable in the estate tax value of the decedent's shares.
- Sorensen – Firehouse Subs case; Wandry clause challenged; valuation challenged; Notice of Deficiency claimed a \$13.6mm tax deficiency; tax penalties of \$5.4mm assessed
 - This case was SETTLED BEFORE TRIAL.
 - Are the defined value clauses respected?
 - Settlement indicates Wandry Clause is ignored, number of shares transferred on 12/31/14 is fixed at 9,385.
 - IRS arguments suggest they approve of Petter, Christiansen, McCord, Hendrix-type clauses.
 - What is the appropriate FMV of the stock?
 - Settlement favored IRS positions; \$17mm valuation adjustments over two dates.
 - Are penalties appropriate?
 - 10% accuracy-related penalty under 6662 applied to 2015 transfer
- Keefer – Application of Assignment of Income Doctrine; donor owned an interest in a hotel partnership that was attempting to sell the hotel; donation made shortly after a verbal agreement to sell was reached; two weeks later a contract was signed to sell the hotel, subject to a 30-day review period. The sale closed 40 days later.
 - Two-prong test on AOID – failed on first test because rather than transferring a 4% interest in the partnership, the assignment was of 4% of the Hotel sale proceeds, effectively carving out some working capital and other items from consideration.

Discounts Allowed in Court

Case	Year	Assets	Court	Total Effective Discount from NAV or Control	DLOM Only
				Value	
Lauder	1994	Common Stock	Tax	50.0%	40.0%
Disanto	1999	Operating Business - Fabric for Clothing	Tax	NA	35.0%
Smith	1999	S corporation - owned/operated a farm	Tax	75.9%	35.0%
Smith	1999	Bank Stock	Tax	38.8%	35.0%
Weinberg	2000	Real Estate - Apartment Complex	Tax	49.8%	20.0%
Adams	2001	Securities/Real Estate/Minerals	Fed. Dist.	54.0%	35.0%
Jones	2001	Real Estate (A VLP)	Tax	44.8%	NA
Church	2002	Securities/Real Estate	Fed. Dist.	63.0%	NA
Peracchio	2003	Cash/Marketable Securities	Tax	31.0%	25.0%
McCord	2003	Securities/Real Estate	Tax	32.0%	20.0%
Lappo	2003	Securities/Real Estate	Tax	35.4%	24.0%
Green	2003	Bank Stock	Tax	46.0%	35.0%
Thompson	2004	Publishing Company	Tax	40.5%	30.0%
Kelley	2005	Cash/Certificates of Deposit	Tax	32.0%	23.0%
Temple	2006	Ranch	Fed. Dist.	38.0%	33.0%
Temple	2006	Winery	Fed. Dist.	60.0%	33.0%
Astleford	2008	Real Estate	Tax	36.0%	30.0%
Murphy	2009	Securities/Real Estate	Fed. Dist.	41.0%	32.5%
Gallagher	2011	Publishing Company	Tax	47.0%	31.0%
Guistina	2011	Timberland	Tax	55.7%	25.0%
Richmond	2014	Large Capitalization Public Equities	Tax	46.5%	32.1%
Kress	2019	Large Operating Business	Fed. Dist.	NA	25.0%-27.0%
Jones	2019	Operating Business / Timberland Owner	Tax	NA	35.0%
Nelson	2020	Operating Business - Equipment Dealer	Tax	40.5%	30.0%
Nelson	2020	Private Company Stock / Minor Other Assets	Tax	31.6%	28.0%
Grieve	2020	Cash, Investments, Notes (two entities)	Tax	34.5% / 35.1%	25.0%
Warne	2021	Real Estate LLCs (Non-Controlling Interest Only)	Tax	27.4%	NA
Smaldino	2021	Real Estate LLCs	Tax	36.0%	NA
Cecil	2023	Hospitality/Historical Resort Property Valued as Going Concern	Tax	35.2%-41.6%	19.0%-27.0%
Median - Overall				40.5%	30.0%
Median - Real Estate / Securities				39.5%	32.5%
Median - Cash / Securities				39.9%	28.6%

Cecil v. U.S.

T.C. Memo 2023-24



Background



- William Cecil, Sr., a descendant of the Vanderbilt family, made gifts of non-voting stock in The Biltmore Company (“TBC”) to each of his five grandchildren. Mary Cecil, his wife, made gifts of voting stock to each of their two children (Bill Cecil, Jr. and Diana Cecil Pickering).
- Gifts were made in 2010. 93% of the non-voting stock was transferred, and 14% of the voting stock was transferred.
- TBC is a Delaware Corporation formed in 1932 that owns the world-renowned French Renaissance chateau known as the “Biltmore House” constructed in the late 1800s and then occupied by George W. Vanderbilt.
- TBC currently uses the property to operate an entertainment, hotel and retail business in and around the mansion and the 8,000-acre underlying property.

Background

- The IRS challenged the valuations of the gifts made by Petitioners, ultimately leading to a trial in 2016.
- Petitioners died while the audit was open, leading to co-executor Bill Cecil Jr. being substituted for the proceedings.
- Respondent's Determined Deficiency: \$13.0mm.
- Two primary valuation issues were addressed:
 1. Whether it was appropriate to apply an entity level tax burden to a pass-through entity.
 2. Whether it was appropriate to appraise a non-controlling interest in an asset-intensive hospitality company using an asset approach.

Tax Affecting

- This issue first centers around whether the earnings of a pass-through entity, such as an S corporation, partnership or LLC, should be reduced by an entity level tax burden when valuing the enterprise.
- Should an S corporation, partnership or LLC be valued based on \$100 of pre-tax, entity-level earnings or an after-tax amount.
- Secondary questions on this point include:
 - What is the appropriate tax rate?
 - Does the single layer of taxation inherent in the pass-through structure add value relative to an otherwise identical C corporation?

Tax Affecting

- Experts on both sides agreed that tax-affecting was appropriate.
- The Court found itself required to agree.
 - The Court highlighted an important statement made in the *Jackson* decision, stating “there is not a total bar against the use of tax affecting when the circumstances call for it.”
 - Then, seemingly in an effort to preempt those wishing to consider the tax-affecting issue now settled, the Court stated, “we are not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation.”

Immediate Takeaways – Tax Affecting

- The USTC made it clear that this issue will be examined on a case-by-case basis going forward, and that the Cecil decision will not close the door on this debate.
- If you have an open audit where tax-affecting is being disallowed, the *Cecil* decision now replaces the *Jackson* case as the latest decision to address this issue, provides further insight into the USTC's approach to this complex issue, and could provide the basis for an audit to be resolved favorably.
- Best practice for taxpayers that are transferring stock in closely held operating businesses structured as pass-through entities for income tax purposes:
 - Obtain a valuation from an appraisal firm that is fully aware of the history of the tax affecting debate and the relevant cases.
 - The valuation firm should be able to articulate the reasoning for tax affecting, apply a methodology that quantifies the differences between otherwise equivalent taxable and pass-through entities, and be prepared to discuss the issue in the audit setting.

Asset vs. Income Approach

- The *Cecil* decision addressed the issue of whether an asset-intensive business ought to be valued on the basis of its underlying net asset value or on the basis of its earnings and cash flow.
- Why is this important?
 - Depending upon the specifics of a given matter, the application of an asset approach may yield a value that meaningfully exceeds that derived through the direct capitalization of that entity's cash flow.
- In Cecil, you have TBC, a corporation operating a world-famous entertainment, hotel and retail business centered around a former Vanderbilt family mansion and sitting on 8,000 acres.
 - The Court clearly viewed TBC as a going concern, operating business.
 - It reasoned further that the hypothetical willing buyer and willing selling of non-controlling interests in TBC would not consider liquidation to be a realistic, potential outcome.
 - The Court concluded that an asset-based approach was irrelevant and placed no weight on underlying net asset value
 - The Court placing full weight upon a valuation based on earnings and cash flow.

Immediate Takeaways – Asset vs. Income Approach

- There are many situations where private businesses may have much lower values using an earnings approach in comparison to an asset approach.
 - Examples: large real estate businesses; large hotel operators; timber businesses; family farms
- For real estate partnerships, we often think of discounts from NAV. Values derived through an earnings approach may be significantly lower.
- While many clients may seem like candidates for the Cecil treatment, the facts must be supportive.
- As a general matter, the Cecil treatment is only applicable when valuing non-controlling interests where there is no liquidity event in the foreseeable future.

Connelly v. U.S.

4:19-cv-01410-SRC

United States District Court, Eastern District of Missouri

Background



- Two brothers, Michael and Thomas, were the only shareholders of Crown C Supply, Inc., a seller of roofing and siding materials in St. Louis, Missouri.
- In 2001, brothers executed a buy-sell agreement that required the Company to buy back the shares of the first brother to die.
- Company bought life insurance to “ensure” it had sufficient cash to fund the redemption
- The owners were obligated under the buy-sell agreement to determine, by mutual agreement, the stock value through execution of a Certificate of Agreed Value at the end of each tax year. If an agreement could not be reached, the owners were to obtain two or more third party appraisals.
 - The brothers never executed a Certificate in the 12+ years since entering into the buy-sell agreement.
- Michael died in October 2013.
- The Estate and Thomas did not obtain a third-party appraisal for estate tax purposes; rather, they came to an agreed value of \$3.0 million for the Estate’s shares, which disregarded the effect of the insurance proceeds and/or treated the redemption obligation as debt of the Company.

Pre-Death Ownership & Valuation

Crown C Supply - Prior to Michael's Death

Equity Value	\$ 3,100,000	
Total Equity Value	<u>3,100,000</u>	
Share Ownership		
Michael	385.90	77.18%
Thomas	<u>114.10</u>	22.82%
Total	<u>500.00</u>	
Implied Price Per Share	\$ 6,200	
Value of Michael's Share	\$ 2,392,580	
Value of Thomas' Share	<u>707,420</u>	
	<u>\$ 3,100,000</u>	

Post-Death Ownership & Valuation

Crown C Supply - After Michael's Death

	Actual	Estate Position
Stipulated Equity Value Excluding COLI	3,100,000	3,100,000
Proceeds from COLI at Death	3,500,000	3,500,000
Redemption Obligation	-	(3,000,000)
Total Equity Value	<u>6,600,000</u>	<u>3,600,000</u>
Share Ownership		
Michael	385.90	385.90
Thomas	114.10	114.10
Total	<u>500.00</u>	<u>500.00</u>
Implied Price Per Share	\$ 13,200	\$ 7,200
Value of Michael's Share	\$ 5,093,880	\$ 2,778,480
Value of Thomas' Share	1,506,120	821,520
	<u>\$ 6,600,000</u>	<u>\$ 3,600,000</u>

The Way the Redemption Should Work for Thomas...

- Thomas should not get a windfall; his equity value should not change materially, if at all...

	Post Death	Post Redemption
Stipulated Equity Value Excluding COLI	3,100,000	3,100,000
Proceeds from COLI at Death	3,500,000	3,500,000
Cash/Notes Used for Redemption	-	(5,093,880)
Total Equity Value	<u>6,600,000</u>	<u>1,506,120</u>
Share Ownership		
Michael	385.90	-
Thomas	114.10	114.10
Total	<u>500.00</u>	<u>114.10</u>
Implied Price Per Share	\$ 13,200	\$ 13,200
Value of Michael's Share	\$ 5,093,880	\$ -
Value of Thomas' Share	<u>1,506,120</u>	<u>1,506,120</u>
	<u>\$ 6,600,000</u>	<u>\$ 1,506,120</u>

The Erroneous Effect of the Estate's Position

- Thomas gets a windfall!!!

	Post-Redemption Actual	Post-Redemption Estate
Stipulated Equity Value Excluding COLI	3,100,000	3,100,000
Proceeds from COLI at Death	3,500,000	3,500,000
Cash/Notes Used for Redemption	(5,093,880)	(3,000,000)
Total Equity Value	<u>1,506,120</u>	<u>3,600,000</u>
Share Ownership		
Michael	-	-
Thomas	114.10	114.10
Total	<u>114.10</u>	<u>114.10</u>
Implied Price Per Share	\$ 13,200	\$ 31,551
Value of Michael's Share	\$ -	\$ -
Value of Thomas' Share	<u>1,506,120</u>	<u>3,600,000</u>
	<u>\$ 1,506,120</u>	<u>\$ 3,600,000</u>

Connelly Takeaways

- Recognize and follow the terms of your own agreements; the brothers clearly did not in this case.
- A buy-sell agreement will not govern for estate tax purposes, unless it is proven clearly to satisfy the three-prong test under Section 2703.
- The proceeds from corporate-owned life insurance is included in the valuation of the subject company.
- In cases such as Connelly, this leads to a “spiraling” effect where the insurance need is substantially more than you think.
- Better options are likely available, including use of cross-purchase agreements and/or employing a separate LLC that owns the life insurance policies.
- “Insurance LLC” >>
 - Separate manager-managed LLC to hold and administer the insurance policies insuring the lives of the business owners.
 - Each member of the LLC is designated as a beneficial owner of the life insurance policies insuring the other members whose ownership interests in the operating entity are obligated to be purchased upon death.
 - The life insurance policies also name the LLC as the beneficiary.
 - Provides centralized management and creditor protection for the policies it holds
 - Avoids estate tax inclusion for its owners, benefits that are not otherwise available when the individual owners hold the policies.
 - An independent person or corporate trustee serves as the manager.
 - Each member of the LLC makes capital contributions equal to the premiums on the life insurance policy with respect to which that member is designated as the beneficial owner.
 - All supported by PLR 200747002.

Audit Activity

Audit Triggers

- What Might Trigger an Audit?
 - Not attaching an appraisal
 - Attaching a draft appraisal
 - Using a taxpayer estimate of value
 - Significant tax dollars at stake
 - Math errors on the return
 - Identification of potential participants in abusive tax avoidance transactions (“ATATs”), including those related to persons or companies identified by IRS as “promoters” of abusive transactions.
 - Quality assessment of the appraisal
 - Is the appraiser a qualified appraiser? Appropriate credentials?
 - Does the content of the appraisal comport with relevant standards? Does it appear to follow USPAP?
 - What valuation methods were used?
 - Does the discount rate make sense?
 - How were valuation multiples derived?
 - How were lack of control and lack of marketability discounts derived? Is the discount for lack of marketability consistent with standards in the IRS DLDM Job Aid?
 - Tax Affecting – was this applied and what tax rates were used? How does the approach compare to what is contained in the IRS S Corporation Job Aid?
 - Other IRS Hot Buttons
 - Wandry clauses
 - Intrafamily transactions; documentation, administration and valuation of notes.
 - Death-bed transfers

Summary of Recently Closed & Active Audits – MPI Clients

Defined Name	Type	Status	Appraised Value of Interests	Proposed Value Adj.	MPI Discount	IRS Discount	Final Discount	Notes
NY Real Estate Entities - Client RR	Estate	Closed	\$ 36,000,000	\$ 1,600,000	30-38%	NA	30-38%	Settled at Exams; MPI Discounts Accepted; Real Estate Values Increased by \$400k.
NYC Real Estate Case - Client AM	Estate	Closed	\$ 39,000,000	\$ 21,000,000	42%	25%	36%	Settled at Exams; MPI used both income and discounted NAV approaches; the IRS accepted the income approach.
PE Fund Interests - Client DB	Gift	Closed	\$ 9,700,000	NA	30%, 41%	NA	30%, 41%	No change letter issued; discounts questioned by accepted after additional materials provided.
Hedge Fund Interest - Client RS	Gift	Closed	\$ 13,500,000	\$ 2,700,000	20%	0%	16%	Settled at Exams. IRS questioned the need or any discount but did not provide anything in writing.
Missouri Media Case - Client N	Gift	Closed	\$ 9,000,000	\$ 1,600,000	37%	28%	NA	Settled at Exams; agent sought a non-technical solution to work around the tax affecting issue; \$260k of gift tax paid.
Boston Real Estate Case - Client H	Estate	Closed	\$ 38,000,000	\$ 10,000,000	40-45%	18-27%	32.5-36.5%	Settled at Exams; Estate willing to pay some tax to avoid litigation and other issues being raised; \$1.65mm of additional tax paid.
Kansas Investment Company - Client AT	Gift	Closed	\$ 6,700,000	\$ 2,010,000	32%	2%	25.5%	Settled at Appeals; Agent and Engineer had made 2703 arguments and compared this to a hedge fund; Appeals Officer agreed that the IRS approach was unwarranted.
Uniform Supply Business - Client C	Gift	Closed	\$ 7,800,000	\$ 1,700,000	34%	26%	34.0%	No change letter issued.
Open Audits								
Large Investment Company - Client HB	Gift	Exams	NA	NA	36%	26%	NA	At Exams, early stages.
Blockage Discount Case - Client DM	Estate	NoD	\$ 146,000,000	\$ 19,000,000	15%	1.7%	NA	Petition filed with USTC.
Florida Note - Client RC	Estate	Exams	\$ 3,700,000	\$ 1,200,000	25%	0%	NA	At Exams.
Ohio Estate - Client DAL	Estate	Exams	\$ 10,000,000	\$ 2,600,000	50%	37%	NA	At Exams, early stages. DoD = March 16, 2020.
NY Real Estate LLCs - Client CB	Gift	CT	\$ 3,600,000	\$ 2,300,000	39%	0%	NA	Early stages.

New York City Real Estate Case: “Client AM”

- Date of death and alternate date were in 2019.
- Estate largely comprised of 35 LLCs that own a single residential, office, or retail property in the Greater NYC area.
- More than half of the properties have been in the family organization for 20-40 years.
- Given this long-term ownership, MPI applied 70% weight to an income capitalization model and 30% to discounted NAV. A single DLOM of 30% was applied against the weighted average value.
- Attorneys for the Estate cited Weinberg (Estate of Etta H. Weinberg, et al, v. Commissioner, T.C. Memo. 2000-51) as having a similar fact pattern regarding weighted methodology (Weinberg used a 75% income cap / 25% NAV weight).
- MPI’s valuation summed to \$39 million; IRS argued the values should be adjusted to \$60 million. The final settlement total was \$43 million.
 - The IRS accepted the income capitalization model, but initially requested a 6.3% discount for lack of control for the NAV method (vs. MPI’s 17.5%) and 20% DLOM.
 - The IRS and taxpayer finally agreed to a 15% discount for lack of control and a 25% DLOM.
- Key takeaways
 - A hybrid income/asset model requires extensive due diligence to understand the organization’s investment policy as it relates to property turnover and the structure of property ownership (i.e., single LLCs vs a single corporate umbrella). A thorough real estate appraisal helps support the discounted NAV analysis and supports the assumptions of a BV appraiser’s income cap analysis. Valuation methods, weightings, etc. are going to vary on a case-by-case basis.

Boston Real Estate Case: “Client H”

- Estate Tax Audit - Gross Estate: \$131mm
- Estate assets dominated by real estate entity interests.
- 18 real estate entities involved; 17 real estate holding companies; one real estate management company.
- IRS challenged the valuation of 7 of the entities on audit; agent brought in an IRS engineer to assist.
- MPI’s valuation of the 7 entity interests summed to \$38mm; IRS argued that the values should be adjusted to \$48mm.
- IRS made significant information requests pertaining to numerous issues/items: ownership; relationships of all members to the decedent; any transfers or third-party transactions; waivers of agreement restrictions; 754 elections; engagement letters with appraisers; copies of all notes; evidence of note payments; interest calculations; evidence of security/collateral given on the notes; evidence that loans meet requirements with respect to interest expense deductibility

Boston Real Estate Case: “Client H”

- Valuation Topics – Round 1
 - Asked for underlying data supporting discounts for lack of control and lack of marketability
 - Concerned that MPI’s restricted stock method was biased by high-tech, start-up, highly leveraged and/or distressed companies doing Rule 144 private placements
- Valuation Topics – Round 2
 - IRS Engineer writes 59-page memo: claims MPI discounts are “excessive”; adjusts based on “Mandelbaum analysis”; claims that the significant cash balances should be segregated from the real estate operations and not subject to the “real estate DLOC” of 14% - instead recommends 2% on account of Perrachio;
 - Recommended DLOCs on real estate of between 10% and 15%; attempts to discard RELP data in favor of closed-end funds
 - Recommended DLOMs between 10% and 15%; applies “Mandelbaum Analysis”
 - Overall discounts between 18% and 27%, vs. between 40% and 45% within MPI Appraisals

Boston Real Estate Case: “Client H”

- MPI Response:
 - Round 1: informational in nature; but also goes one step further given where the questions will logically lead
 - Round 2:
 - MPI does its own version of the “Mandelbaum analysis”, demonstrating that the engineer’s application was incorrect and came to the wrong conclusions
 - MPI buttresses its DLOM analysis with further explanation and presents numerous USTC and Federal District Court decisions supporting its range of discounts
 - MPI demonstrates that closed-end funds are worse analogs as they own interests in publicly traded REITs rather than owning real estate directly
 - MPI points out significant flaws in the engineer’s use of alternative marketability discount studies
 - MPI conducts a study of the cash levels of each of the guideline real estate partnerships used to determine the DLOC. MPI finds that the ratio of cash to total assets within the client entities are within the observed range of the guideline real estate partnerships, thus debunking the concept that cash ought to be segregated as the IRS posits.

Boston Real Estate Case: “Client H”

- Conclusion:
 - The management of the case by the estate’s counsel and the multiple rounds of responses on valuation issues ultimately leads to a negotiation with the agent.
 - The estate’s counsel expresses a willingness to go to IRS Appeals; the agent expresses a willingness to settle and the ability to move off the engineer’s positions
 - The family was willing to pay up to \$3.0mm in additional tax to resolve the matter given other potential issues and litigation risk
 - Settlement is reached with the following discounts:
 - DLOCs of 12.5% to 17.5%
 - DLOM of 23.0%
 - Total effective discounts in the range of 32.6% to 36.5%; slightly better than “splitting the baby”
 - Additional total tax of \$1.65mm is due

Missouri Media Case: “Client N”

- Gift tax audit involving the transfer of stock in a media company
- MPI value per share: \$6,200 per share
- IRS value per share: \$8,100 per share (+30.6%)
- Implication: \$1.6mm in gift tax owed
- Issues:
 - All about valuation
 - **Tax affecting of cash flows in the DCF**
 - Multiples applied
 - How to calculate value in the DCF “terminal period”
- On tax affecting, the agent stated in writing:
 - “The IRS position is that in almost no case is it proper to tax affect the entity level income stream(s) being utilized for the valuation of S corporation interests. The only notable exception is where it can be clearly and conclusively demonstrated that due to the universe of hypothetical buyers the ultimate buyer will, more likely than not, be a C corporation, thus causing the target entity to lose its tax-advantaged status...”
 - The entity’s stock restriction agreement “restricts the disposition of any stock that after such a transfer the Company could not continue as an S corporation
 - MPI did not apply an S Corp. premium due to the facts at hand; deemed the C Corp. and S Corp. values to be roughly equivalent.

Missouri Media Case: “Client N”

- Response:
 - MPI found errors in the engineer’s DCF; MPI proved by reference to textbooks and valuation literature that the engineer’s approach to the terminal value was flat wrong.
 - Correcting the IRS DCF led to the IRS having a value from the income approach that was substantially lower than the value from the market approach, calling into question the whole analysis.
 - MPI demonstrated that no S Corp. premium applied due to the lack of a favorable distribution policy and the relative effective tax rate differentials of taxable and pass-through entities. MPI used the Jones and Kress decisions to support its use of the “C to S Method” for valuing pass-through entities.
 - IRS held firm to the no-tax-affecting stance, indicating its “hands were tied”

Missouri Media Case: “Client N”

- Conclusion:
 - After a series of memos were exchanged and phone calls were had, the agent expressed a willingness to seek a “non-technical” solution
 - Negotiation resulted in an agreed-upon value of \$6,500 per share (+4.8% from the original appraisal)
 - The result was additional gift tax owed of approximately \$260k and a very happy taxpayer.

Kansas Investment Company: “Client AT”

- Gift Tax Audit - 2018
- Investment entity held assets of \$6.7 million, consisting mostly of marketable securities and cash (90.0% of assets). Entity also held a promissory note (7.5% of assets) and a small private investment (2.5% of assets).
- Entity formed in 2015, gifts made in 2018 of one-third interests to each of three trusts.
- MPI’s appraisal contained discounts to net asset value as follows:
 - DLOC: 8.0%
 - DLOM: 26.0%
 - Overall effective discount: 32.0%
- IRS challenged the valuation on audit; agent brought in an IRS engineer to assist.
- IRS Engineer argued that the investment company resembled a hedge fund, and therefore should have agreement features resembling that of a hedge fund. The IRS Engineer argues that a hedge fund would allow monthly or quarterly redemptions and that anything more restrictive would violate Chapter 14.

Kansas Investment Company: “Client AT”

- Conclusion:
 - There is not enough time remaining on the statute to go directly to Appeals.
 - Case was docketed for Tax Court in early 2023.
 - Case sent back to Appeals; in-person conference requested by the Appeals Officer.
 - Appeals conference occurs in October 2022.
 - A lengthy appeals conference ultimately reached a settlement.
 - IRS representatives very sharp/organized, realized they had a bad valuation from the IRS Engineer, but felt they could get a new one in time for trial.
 - The IRS accepted the DLOC (8.0%) that MPI applied and then the parties agreed to a reduced DLOM of 19%.
 - Total effective discount of 25.5%.

IRS CCA 202152018



What is a CCA?

- Chief Counsel Advice or “CCA” is a document issued by any national office component of the Office of the Chief Counsel of the Internal Revenue Service to field or service center employees of the IRS or regional or district employees of the Office of Chief Counsel...
- The purpose of CCA is to convey (1) any legal interpretation of a revenue provision; (2) any IRS or Office of Chief Counsel position or policy concerning a revenue provision; or (3) any legal interpretation of State law, foreign law, or other Federal law relating to the assessment or collection of any liability under a revenue provision.
- CCA includes both taxpayer specific and nontaxpayer specific advice.
- The type of CCA referenced herein is typically issued as a result of field-level Service employees requesting guidance on a topic; per the 1998 IRS Restructuring & Reform Act (and resulting from prior Freedom of Information Act (“FOIA”) lawsuits), CCA’s must be made available publicly, albeit with redactions to exclude taxpayer information.



Issues & Conclusions

- Issues:
 1. Whether, under the circumstances described below, the hypothetical willing buyer and willing seller of shares in a company would consider a “pending” merger for purposes of valuing stock for gift tax purposes.
 2. Whether Donor retained a qualified annuity interest in Trust when Donor used an outdated appraisal that did not take into account all the facts and circumstances of a pending merger.
- IRS Conclusions
 1. Yes. Under the fair market value standard, the hypothetical willing buyer and willing seller of a company would consider a “pending” merger when valuing stock for gift tax purposes.
 2. No. The retained interest is not a qualified annuity interest under §2702 of the Internal Revenue Code because Donor used an outdated appraisal that did not take into account all the facts and circumstances of a pending merger.
 - The transferor is treated as having made a gift equal to the full finally determined value of the assets contributed to the GRAT; there is **no offset** for the value of the retained annuity payment rights.



Summary of Facts

- At “Time Zero” or “T”, business owner contacted Investment Banks (“IBs”) to find a third-party buyer.
 - Shortly thereafter, the business was marketed to potential buyers, including some that had expressed interest in merging with the company in the past.
 - Potential buyers were expected to purchase a minority interest, with a call option to purchase the remainder of the company in several years based on a formula.
- Six months after hiring the IBs (“T+6” or “Date 1”), IBs presented owner with five offers.
- Three days later (“Date 2”), owner funded a two-year GRAT with shares of the company. Annuity payments were to be based on the appraised fair market value of the shares as of Date 2.
 - Owner used an appraisal contemporaneous with Time Zero, which is when owner began marketing the company. This appraisal did not include any language or analysis pertaining to a potential sale/merger, and the appraisal was prepared for 409a purposes.

Summary of Facts

- At T+9 (“Date 3”) the company received final offers, with four companies increasing their offers and one company withdrawing from the process.
- At T+11 (“Date 4”), owner made a contribution of shares to a Charitable Remainder Trust (“CRT”). Owner procured a qualified appraisal that opined to a value consistent with the offering price ultimately accepted by the company at T+12 (“Date 5”).
 - The tender offer accepted on Date 5 was approximately 3 times greater than the appraised value at Time Zero.
- At T+12 and T+24, 409A appraisals were again obtained. The values both came in below the offer price (at approximately 2 times the Time Zero 409A appraised value).
 - These 409A appraisals included the following language: “there have been no other recent offers or closed transactions in the Company shares as of the valuation date.” This language was not included in the 409A valuation at Time Zero.
- At T+36, and approximately 6 months after the two-year GRAT term expired, the buyer exercised its option to purchase the balance of the company shares; the value was almost four times the value used for the GRAT formation.
- When asked why they used the 409a valuation from Time Zero for purposes of the initial GRAT funding several days after the Company had received bids, the taxpayer stated that the business operations had not materially changed.



What Went Wrong?

- Using a 409A appraisal for a transfer tax matter (GRAT)
- Giving no consideration to the value implied by the purchase offers at the date of the GRAT contribution
- Using a six-month old appraisal in a case where value was clearly changing due to the sale/merger process
- Doing something entirely different for charitable purposes, seemingly to take advantage of the higher value
- For charitable purposes, it appears aggressive to use the finally accepted offer price one month prior to the actual acceptance date.



Takeaways - GRATs

- The IRS is being aggressive in pursuing GRATs that it believes have been formed improperly and/or not administered correctly.
- Taxpayers and advisors should not take for granted the adjustment features of a typical GRAT structure; if IRS finds significant flaws in the setup and administration, the consequences could be severe and adverse. The consequences could include having the entire amount contributed to the GRAT being treated as a gift and a 40% undervaluation penalty.
- The GRAT is not a license to use an overly aggressive valuation position, whether that be relying on a bad appraisal, stale appraisal, using a low value without obtaining an appraisal, or otherwise.
- GRAT as a safety valve, yes, so long as the formation and administration is done properly.

Takeaways - General

- This is yet another case that planners should use to warn clients of the dangers in (1) waiting too long to conduct estate planning and/or (2) using appraisals that are poor quality, stale or prepared for a different purpose.
- This CCA can be used as another hook to get clients to move on estate planning now, before there is the threat of a liquidity event. Taxpayers are looking for trouble if they wait to do their estate planning until a sale of the company starts coming into focus.
- Further problems will then arise if the potential sale/merger isn't considered in the valuation. Taxpayers need to be forthright with their valuation professionals about the potential for liquidity events and the status of any negotiations or dialogue.
- Taxpayers should be aware that one of the most scrutinized areas is the intrafamily transfer in the months before a sale/merger.

409A Appraisals

- Can we use them or not in the transfer tax context?
 - Often the answer is simply NO, because they are prepared for a specific income tax purpose and the appraisers often prohibit its use for any other purpose.
- There could be a set of biases present when conducting a 409A appraisal that causes the value to diverge from what might be determined by a qualified appraiser in the transfer tax context. This is mainly driven by the fact that these appraisals are sought in the context of equity-based compensation, including granting stock or stock options.
- 409A valuations are conducted under the same “fair market value” standard applicable in the transfer tax world. However, 409A valuations are often influenced by “fair value” (financial reporting) standards due to parallel usage for financial statement purposes. This may cause value to diverge from fair market value.
- Many 409A appraisals are obtained “on the cheap” and lack rigor, possibly because information is limited or unavailable, and/or the company procuring them has limited resources. Therefore, these appraisals may simply not hold up under the most basic scrutiny inside the transfer tax world.
- The taxpayer might not have access to the actual report and may only be relying on oral or written representation by the company or an officer of the company of the value per share. Without any supporting detail, it would appear impractical for the taxpayer to satisfy adequate disclosure regulations. This may also be true when having the report, as many 409A reports are heavy on exhibits and light on text.
- Valuation date may differ from the transfer date; what transpired in the intervening period?
- You might ask the appraisal firm if they can leverage the work done for the 409A and prepare a separate appraisal for transfer tax purposes. Otherwise, the taxpayer may be taking on significant risk when using a 409A appraisal in the transfer tax context.



How IRS Views Potential Sale/Merger

- The CCA points to many USTC cases that state that an appraisal needs to consider all relevant facts that a hypothetical willing buyer and willing seller would consider in a transaction.
 - Case references: Bank One Corp, Simplot, Redstone, McCord, Newhouse, Kollsman, Trust Services of America, Inc., Gilford
- Kollsman: relevant facts that may not be known by the owner of the property should also be considered in the valuation if such facts could be known after a reasonable investigation.
- Trust Services of America, Inc.: a post-valuation date event could be considered if it was reasonably foreseen.
- Gilford: an unforeseeable future event could be used to the extent that such transaction could establish an amount that a hypothetical buyer may pay a hypothetical seller.
- Takeaway – ignore potential sale/merger transactions at your own peril; using the hard and fast “known or knowable” as of the valuation date is not a panacea; “knowable” provides significant latitude.



MPI's Approach - Potential Sale/Merger

- Thorough diligence with business owners and/or representatives of the company.
 - Press the owners/managers on any negotiations, discussions or even plans pertaining to current or future M&A activity.
- Request documentation (board packages, IB decks, financial projections, indications of interest received, letters of intent received, etc.) on or prior to valuation date that can explain where any activity stood on the exact valuation date. Nail down the timeline.
- Based on what is learned in diligence, there are typically four outcomes:
 1. No activity existing or planned; value company as-is.
 2. Sale of company is the goal; investment bankers may have been hired
 3. IBs have solicited and received indications of interest (“IOIs”)
 4. The Company has received a signed letter of intent (“LOI”) and is negotiating and permitting further diligence exclusively with one party.



MPI's Approach - Potential Sale/Merger

- Four potential outcomes:
 1. Ownership not considering any M&A activity and near-term likelihood of any M&A activity is low - Value the company as-is, on a privately-owned basis; traditional discounts for lack of control and lack of marketability apply presuming the transferred asset is a non-controlling stake.
 2. Ownership has had initial discussions internally, or perhaps with investment bankers on the possibility of M&A activity in the relatively near future – (1) Value the company as-is on a privately-owned basis, (2) Value the company based on the most likely M&A transaction to occur. Ultimately, place weights on each scenario based on the appraiser's assessment of the likelihood of each to occur.
 - The M&A value could be based on the projected terms of a potential deal, a value that IB's have mentioned the company could achieve, or an independent enterprise valuation by the appraiser.
 3. IOIs received; same as #2, with more clarity as to potential sale value and potentially more weight given to a sale occurring.
 4. Ownership has a signed LOI – Valuation should be based on the present value of all cash flows (including cash, earnouts, rollover equity, etc.) to the seller resulting from a completed sale/merger deal. The appraiser must attempt to understand the risks of the deal falling through at this stage. If the risks are material, a discount to the sale value, albeit small, may be warranted.
 - Importantly, if the purchase consideration includes rollover equity and/or earnouts, meaningful discounts from the headline price may be warranted for those components.