Symposium—What Estate and Trust Counsel Say about the Current State of Estates and Trusts

Fady F. Bebawy

This Insights *symposium presents a series of questions and answers between our* Insights *issue editor and a panel of distinguished and seasoned estate and trust counsel from across the United States. These legal counsel practice in the area of estate planning, trust administration, and transactional matters. These legal counsel share their experience and expertise with regard to judicial developments in estate planning, estate administration, estate tax compliance, and estate tax controversies.*

Introduction

The practice of trusts and estates law is an area that is far reaching. The old adage says that the only two certainties in life are death and taxes. The legal discipline of estates and trusts deals directly with these two inevitabilities. Accordingly, trust and estate law may touch each one of us.

If trusts and estates counsel are the "conductors" of the metaphorical symphony of the estate plan, then valuation analysts play one of the important "instruments."

Figure 1, defined as the intergenerational wealth transfer management (IWTM) continuum, illustrates the "solo" parts where valuation analysts perform their role in the estate planning process.

That valuation analyst role is performed in the development of—and in the execution of—the estate plan.

That is, business and security valuations are often required when a high net worth individual transfers wealth to children or to others by way of:

1. a gift,
2. a generation-skipping transfer, or
3. an estate transfer.

Valuation analysts may also get involved in estate tax controversy matters when the estate transfer is challenged by the Internal Revenue Service (the "Service").

Since estate planning is an area that affects many of us, it should be helpful to our readers to learn from tax law experts with regard to the following issues:

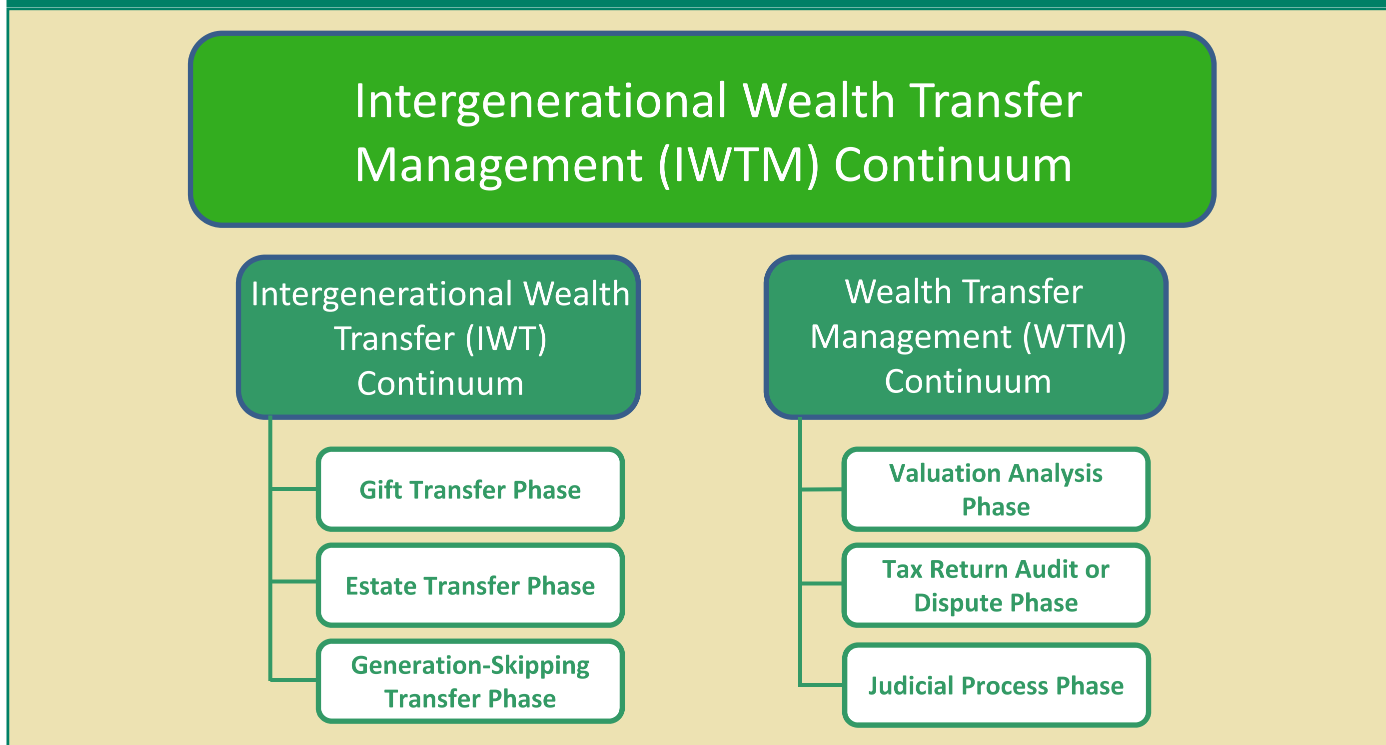
1. What services are included in their practice areas?
2. What is some of the salient case law that affects their practice?
3. When are valuations required?
4. What are the challenges?
5. What should we do?

Our symposium panel is comprised of Matthew S. Beard, a partner with Meadows, Collier, Reed, Cousins, Crouch & Underman, L.L.P., and Adam M. Damerow, an associate with McGuireWoods LLP.

Matthew Beard's practice spans two broad areas of taxation: (1) estate planning and (2) probate and income tax and business planning.

In his estate planning and probate practice, Mr. Beard designs and implements estate plans and business succession plans with an emphasis

Figure 1
Intergenerational Wealth Transfer Management Continuum



on federal tax issues. He often works closely with accountants, bankers, and other financial advisers during this planning process.

Mr. Beard also represents fiduciaries in all facets of estate and trust administration. This representation typically includes court proceedings, tax matters, administration and transfer of assets, and matters before the Service.

Mr. Beard is the author of *An Introductory Guide to Tax and Estate Planning*, which provides an introduction to estate planning under Texas law and planning for federal estate, gift, and generation-skipping transfer taxes.

With regard to transactional matters, Mr. Beard advises clients with a focus on tax issues. He works with a broad range of entities, such as partnerships, limited liability companies, and publicly traded C corporations. Common transactions include formations, acquisitions/mergers, and liquidations.

Mr. Beard is also the author of *Annotated Tax Provisions for Limited Liability Companies*, which includes tax provisions for company agreements with explanations of how the provisions operate and provide pass-through taxation.

Adam Damerow concentrates his practice on estate planning and administration for professionals, executives, closely held business owners, and other high net worth individuals.

His experience includes the preparation of various estate planning documents, ranging from wills, revocable trusts, and powers of attorney to work on generation-skipping transfer tax-exempt trusts, sales to grantor trusts, GRATs, and formation of family LLCs/partnerships.

Mr. Damerow also has experience practicing in Illinois probate court and in federal tax controversy work against the Service.

Mr. Damerow devotes a significant part of his practice to advising nonprofit entities, including private foundations and public charities, on compliance, administration, and funding issues at state and federal levels. He also regularly prepares corporate documents for family-owned businesses, including buy-sell agreements and business formation and operation documents.

Mr. Damerow also advises U.S. citizens living in the United Kingdom on multijurisdictional tax issues.

Symposium Discussion

Insights: Please describe your legal practice and your specific subject matter expertise.

Beard: I am a tax attorney and partner with Meadows, Collier, Reed, Cousins, Crouch & Ungerman, L.L.P., in Dallas, Texas. I focus on estate planning and transactional matters, which typically involve partnerships and trusts.

Damerow: I am an estate planning attorney in the Private Wealth Services Group of McGuireWoods. Our typical clients are high net worth individuals who are often first generation, wealth-creating business owners and executives.

We assist our clients in all aspects of their estate planning, from establishing basic estate and business succession plans to designing and implementing wealth transfer strategies whose primary goal is to maintain the family's wealth for both the current and future generations.

We also represent fiduciaries in contested estate and trust administration matters.

Insights: Please identify and briefly describe any judicial precedent that you find most useful in the estate planning for—and the executing of—intergenerational wealth transfers.

Beard: I find it interesting to compare *Kimbell v. U.S.*[1] and *Strangi v. Commissioner.*[2] The decisions are examples of successful and unsuccessful implementation of an estate plan.

Although the facts share many similarities, the courts reached different results. In both cases, the taxpayer hired an attorney to prepare and implement a partnership as part of an estate plan, partnership formalities were followed during formation and funding, the partnership was formed shortly before the taxpayer's death, and a significant amount of cash and securities were transferred to the partnership.

The taxpayers lived in the same state, and the cases were considered by the same Court of Appeals during the same period of time. Nevertheless, the partnership in *Strangi* was disregarded for federal estate tax purposes, whereas the partnership in *Kimbell* was not. A few important facts led to this result.

In *Strangi*, the taxpayer contributed 98 percent of his wealth, including his residence, to the partnership, distributions were made thereafter for personal expenses, and the taxpayer continued to live in the residence.

In contrast, the taxpayer in *Kimbell* retained sufficient assets for anticipated living expenses, did not use partnership property for personal purposes, and the partnership held an operating oil and gas business.

These judicial decisions indicate that the proper implementation of an estate plan is critical to the success of that plan.

A person involved with the transfer of property to an irrevocable trust that is intended to be excluded from a taxpayer's estate should know of Revenue Ruling 95-58. In that ruling, the Service revoked its prior position with respect to a grantor's reservation of a power to remove a trustee and appoint a new trustee.

The Service's current position is that a grantor who possesses a power to remove a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the grantor (within the meaning of Section 672(c)) will not be treated as retaining the trustee's discretionary control over trust income.

Professional advisers involved with a transfer that requires the reporting on a tax return should be familiar with the limitations on assessment and collection contained in the regulations under Section 6501.

The Section 6501 regulations provide safe harbors for the adequate disclosure of a transfer on a return, whether the transfer is a gift or a nongift completed transfer. Importantly, the regulations include a safe harbor for the submission of an appraisal in lieu of certain financial data.

Damerow: We have recently resolved several transfer tax audits where the central issue was the appropriate marketability and control discounts applicable to the client's closely held business interests where the underlying company assets were marketable securities.

In several of these cases, the Service cited and relied on the *Estate of Curry v. United States,*[3] which extensively cites *Ahmanson Foundation v. United States.*[4]

In addition to the standard recitation of the willing buyer/willing seller test, the court in *Curry* says that if the taxpayer owns a controlling block of voting shares in a company, then the value of the taxpayer's nonvoting shares will be the same value as the taxpayer's voting shares (i.e., no additional discount for the nonvoting shares).

This is one of a number of reasons why we use our best efforts to convince our clients to relinquish voting control of the company as early as possible, which is often easier said than done.

However, even if a client dies with voting control of the company, there are certain protections afforded minority shareholders under state law and/or the controlling company documents (such as liquidation rights) which can help to provide a

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valuation ceiling for a controlling shareholders' interest. *Curry* addresses these issues as well.

Therefore, we found that *Curry* and its progeny are a useful set of cases for both the Service advisers and the taxpayers advisers. This is because these cases help to define the landscape of valuation issues that need to be considered where a client retains voting control and which may arise during planning, implementation, tax reporting, and audit.

Insights: How often do the cases that require valuation services get challenged by the taxing authority? What trend have you seen, if any, in the past five years regarding the incidence of taxing authority challenges to valuations?

Beard: Two things are certain in life—death and taxes. Estate planning deals with both. The Service continues to be vigilant. I have seen fewer examinations for estates with less than $10 million, and more examinations for large estates.

When a closely held business is involved, the Service has recently focused on valuation issues rather than on application of Section 2036.

Damerow: Based on our recent observations and anecdotes, it appears that the rise in the applicable federal estate tax exemption, which necessarily reduced the number of taxable estates, has led to an increase in the number of estate tax returns receiving closer scrutiny by the Service. However, not all of this scrutiny led to adjustments.

The Service knows that if it takes a close look at a tax return that includes an asset with a valuation discount, there is an opportunity to extract additional transfer tax dollars from the taxpayer.

We have also seen situations where once the client's gift tax return is audited, so too are the family's later gift and estate tax returns (i.e., once a client is on the Service's radar, we assume every return will be audited and keep in mind the past audit experience when preparing future transfer tax returns).

The good news is, despite an increased number of our clients' returns being audited by the Service in recent years, in cases where an adjustment is made, the taxpayer still secured significant valuation discounts.

More importantly, the client still comes out significantly ahead of where they would have been had they done no planning, or where they would be if they had a bad (or no) valuation.

Insights: What are the most commonly disputed areas in the valuation that the taxing authority is challenging? How have the nature of the taxing authority challenges changed, if any?

Beard: The amount of discounts for a closely held business is a common dispute. The Service challenges the valuation methodology and value conclusions contained in the appraisal filed with the taxpayer's return.

I have recently seen the Service challenge the methodology used by a valuation analyst where the taxpayer owned both general and limited partner interests in a partnership.

The Service also argued that the discount for lack of marketability (DLOM) should be based on empirical studies other than the studies used by the appraiser.

Damerow: Without question, the most common area of dispute in valuation cases we are seeing is the appropriate DLOM applicable to interests in closely held business entities. This issue arises regardless of whether the company is in fact an operating business or is a holding company consisting of various liquid and illiquid family assets.

Such a challenge likewise applies to tiered-discount situations as well where a client gifts a holding company interest that owns shares in a closely held operating business.

In several audits, we have also seen the Service express a strong, if not complete, preference for applying the net asset value business valuation method, as opposed to the discounted cash flow business valuation method, when determining the value of a noncontrolling ownership interest in a holding company consisting of marketable securities.

Also, as reported many other places, the Service has a strong disdain for valuation discounts on promissory notes for loans between family members.

Insights: Based on your experiences, what advice can you provide estates, family offices, and other intergenerational wealth transferors with regard to (1) estate planning and (2) retaining valuation services?

Beard: An estate plan is similar to a house. Both start with a well-drafted plan. However, the preparation of estate planning documents by an attorney does not mean the estate plan is complete, just like the preparation of house plans by an architect does not mean the house is complete.

I frequently see problems arise from the implementation of an estate plan.

A person should carefully consider his or her fiduciary appointments, such as the executor and trustee. The fiduciary has control over investment and distribution decisions and, thus, is critical to the success of the day-to-day operations of an estate or trust. Incomplete transfers are a common error.

Certain assets, such as real property and entity interests, have specific transfer requirements that should be satisfied to complete a transfer. Reporting errors are another common error. Certain transfers are required to be reported on a federal gift or estate tax return.

The risks associated with reporting can be reduced by satisfying the requirements of a safe harbor, such as the appraisal safe harbor under Section 301.6501(c)-1(f)(3) of the Treasury Regulations.

I typically engage a qualified valuation analyst to prepare an appraisal that meets the requirements of the safe harbor when reporting a significant transfer.

Damerow: With regards to estate planning, most strategies take time to implement. Clients are well served if they are thoughtful about their planning goals and take a long-term approach to their wealth transfer planning. This means beginning the wealth transfer discussion as early as possible and staying engaged throughout the process.

Clients and their professional advisers should always be on the lookout for wealth transfer opportunities, just as they are often on the lookout for opportunities to minimize income taxes.

We also encourage clients to implement a number of strategies over time, such as using GRATs, gifts, and installment sales to grantor trusts, to increase the likelihood that one or more strategies will be successful.

To the extent we can provide it, clients like certainty. With respect to valuations, clients need to know:

- that they have provided adequate disclosures to the Service, via the tax return and its exhibits, to start the statute of limitations running as soon as the return is filed;
- that the valuation positions taken on the return are adequately supported by the analysis in the valuation; and
- in the event of an audit, the client's possible exposure to additional transfer tax based on both valuation discounts taken in the valuation.

Therefore, thoughtful analysis in the valuation is an important component for successful wealth transfer and also in meeting clients' expectations.

Insights: What are your thoughts on the expected proposed regulations under Section 2704 and potentially how will they affect valuation estate planning and disputes with the taxing authority as they relate to valuation services for gift and estate taxes?

Beard: The proposed regulations will be the most important piece of tax law for estate planning since ATRA. The Service is expected to use the regulations as a new approach for challenging discounts associated with closely held businesses.

I anticipate that uncertainties will exist under the new rules, and those uncertainties could potentially lead to litigation similar to the history of Section 2036.

Damerow: The Service has said very little about the substance of the expected proposed regulations under Section 2704. Nevertheless the estate planning community has been abuzz with speculation as to whether the regulations will be limited to certain family situations or broad enough to capture many common planning strategies.

One thing we do know is that the effective date of the proposed regulations is critical. If, as many expect, the regulations have a future effective date, and if the regulations are broad enough to affect many common wealth transfer situations, then we could certainly see clients rush to implement strategies just as we saw at the end of 2012.

On the other hand, if the effective date does not allow time to implement additional planning that would be affected by the proposed regulations, then there will be a sad adviser chorus of "I told you you should have done more planning."

About the only thing we can do now is let our clients know change may be coming and remind them of the potential opportunities available to them today.

Summary and Conclusion

The increase in the federal estate tax exemption has appeared to affect the way in which the Service audits estate tax, gift tax, and generation-skipping transfer tax returns. While fewer estates are taxable, there are more examinations of estates greater than $10 million than before. Also these estates are receiving more scrutiny than ever. There is a greater overall audit risk for taxpayers as well—if a taxpayer is audited for a gift tax return, it is more likely that the Service will continue to audit subsequent gift and estate tax returns for this taxpayer.

The Service also seems to be focused on the elimination of valuation discounts with regard to closely held business interests transferred within an intergenerational (or other intrafamily) wealth transfer.

Along this line, with regard to the expected proposed regulations to Section 2704, the Service has totally abandoned the statutory and judicial definition of fair market value—that is, the price that would be agreed to between a hypothetical (and unrelated) willing buyer and a hypothetical (and unrelated) willing seller.

Insights would like to thank our symposium participants for sharing their experience and expertise with our readers with regard to the current trends in federal gift tax, estate tax, and generation-skipping transfer tax matters.

Notes:

1. Kimbell v. United States, 371 F.3d 257 (5th Cir. 2004).
2. Strangi v. Commissioner, 417 F.3d 468 (5th Cir. 2005).
3. Estate of Curry v. United States, 706 F.2d 1424 (7th Cir. 1983).
4. Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981).

Fady Bebawy is a vice president in our Chicago practice office. Fady can be reached at (773) 399-4323 or at ffbebawy@willamette.com.