WHAT EVERY FAMILY BUSINESS AND FAMILY OFFICE NEEDS TO KNOW

PRESENTED BY

DAVID D. AUGHTRY

CHAMBERLAIN, HRDLICKA, WHITE, WILLIAMS & AUGHTRY

email: david.aughtry@chamberlainlaw.com

ATLANTA
Thirty-Fourth Floor
191 Peachtree Street, N.E.
Atlanta, GA 30303
(404) 659-1410
(800) 800-0745

HOUSTON **PHILADELPHIA** **SAN ANTONIO**

ABOUT THE SPEAKER

DAVID D. AUGHTRY (B.A., The Citadel, 1975; M., Acctcy., University of South Carolina, 1978; J.D., University of South Carolina, 1978; LL.M., Taxation, Emory University, 1982). David is the managing partner in the Atlanta Office of Chamberlain, Hrdlicka, White & Aughtry. David practices in the area of civil tax controversy. In his prior life, he served as the Trial Attorney and Tax Shelter Coordinator for the Office of Chief Counsel, Internal Revenue Service (1978-82) where he tried, among others, *Walker v. Commissioner*, T.C. Memo. 1982-495 (determination of hypothetical development highest and best use for charitable contribution of land) before joining Chamberlain, Hrdlicka and defending various estate, gift, and valuation charitable cases of significance. They include *Commissioner v. Estate of Hubert*, 520 U.S. 93 (1997) (no reduction of marital or charitable estate tax deduction for Form 1041 administrative expenses); *Caracci v. Commissioner*, 456 F.3d 444 (5th Cir. 2000) (shifting burden of proof to IRS on valuation); *Estate of Lassiter v. Commissioner*, T.C. Memo. 2000-324 (disclaim 50 percent marital deduction into full); *Estate of Rogers v. Commissioner*, T.C. Memo. 2000-133 (special use valuation for timberland); *Barnes v. Commissioner*, T.C. Memo. 1998-413 (enterprise and discount value of closely-held stock based on pattern of actual dividends). David taught tax controversy as an Adjunct Professor at Emory University School of Law (1987-93, 1997-98, 2003), and served as an instructor for the National Institute for Trial Advocacy, "Litigating before the United States Tax Court" program (1993-2000). He is a Fellow in the International Society of Barristers and in the American College of Tax Counsel. David served as president of the 2010 Southern Federal Tax Institute.

WHAT EVERY FAMILY BUSINESS AND FAMILY OFFICE NEEDS TO KNOW

Table of Contents

WHAT EVERY FAMILY BUSINESS AND FAMILY OFFICE NEEDS TO KNOW

Presented By

David D. Aughtry

I. **<u>Income Tax Aspects: What Does It Mean To Have A Business</u>?** The income tax fate of the family business turns largely on the distinction between a Section[1] 162 "trade or business" and a Section 212 "production of income" activity. For years, that distinction could prove painful. Today, and until January 1, 2026, that distinction could prove catastrophic for the unwitting family business that fails to meet the requirements of Section 162.

A. **<u>Tax Impact of the Section 162/212 Distinction</u>.**

1. **<u>Section 162: Ordinary and Necessary Expenses of a Trade or Business</u>.** If an activity qualifies as a trade or business under Section 162, the taxpayer may deduct expenses incurred in carrying on that trade or business in full – even if the expenses exceed the income from the activity. Such excess creates a Net Operating Loss which may be carried forward indefinitely to any taxable year to offset operating income in that year. Code § 172(b)(1)(A).[2]

2. **<u>Section 212: Expenses Incurred in the Production of Income</u>.** If the activity does not reach the level of a trade or business but was engaged in by the taxpayer with a profit/income motive, then Section 212 allows the taxpayer to deduct the expenses. However, these expenses, unlike Section 162 expenses, are subject to the alternative minimum tax under Section 56(b) and cannot form part of a Net Operating Loss carryover under Section 172(d)(4). Perhaps most notably, Section 212 expenses constitute itemized deductions under Section 63(d) and miscellaneous itemized deductions under Section 67(b). *See also* Treas. Reg. § 1.67-2T(a)(1)(ii). This designation limits the total amount of Section 212 expenses allowed as a deduction.

---

[1] All references to "Section" or "Code" refer to the Internal Revenue Code of 1986, as amended, unless otherwise stated.

[2] Prior to January 1, 2018, the NOL could be carried back 2 years and only carried forward for 20 years.

a. **Prior to January 1, 2018.** For tax years beginning before January 1, 2018, Taxpayers could only deduct miscellaneous itemized deductions if, and to the extent, they exceeded (in aggregate) 2 percent of the adjusted gross income of the taxpayer. *See* Code § 67(a). That is, Section 67(a) applied a 2-percent floor to miscellaneous itemized deductions which would limit the amount of the deduction to the taxpayer. For the unwitting taxpayer, this could have a minor to moderate negative impact – depending on the particular taxpayer.

b. **Tax Cuts and Jobs Act, Pub. L. 115-97, Title I, § 11045(a), 131 Stat. 2088 (Dec. 22, 2017).** On December 22, 2017, Congress enacted Section 67(g) which disallows the deduction for "miscellaneous itemized deductions," including expenses qualifying under Section 212, for tax years beginning on or after January 1, 2018. Section 67(g) applies to all miscellaneous itemized deductions for the 2018 through 2025 tax years.[3] Thus, a family business may find itself without the ability to deduct expenses if they do not qualify as a trade or business expenses under Section 162.

B. **Section 162: Trade or Business.** Section 162 permits taxpayers a deduction for all ordinary and necessary expenses incurred in carrying on a trade or business. For an expense to qualify for the deduction under Section 162(a), the amount must be (1) paid or incurred in the taxable year, (2) in connection with a trade or business, and (3) ordinary and necessary. *See Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 352 (1971) (internal citations omitted).

1. **Paid or Incurred in the Taxable Year.** Whether an amount is paid or incurred in a taxable year turns largely on the taxpayer's method of accounting and the particular facts of the expense. For cash method taxpayers, this remains a simple inquiry into whether and to what extent funds were relinquished to the designated payee. For accrual method taxpayers, the inquiry becomes slightly more complicated by the "all events" tests. The all events test asks whether all events have occurred to establish the payee's right to payment and the amount of the expense can be determined with reasonable certainty. *See United States v. General Dynamics Corp.*, 481 U.S. 239, 242 (1987).

[3] On September 13, 2018, the House Ways and Means Committee passed the Protecting Family and Small Business Tax Cuts Act of 2018, H.R. 6760 as part of "Tax Reform 2.0." Section 145 of H.R. 6760 would permanently eliminate the Section 67 deduction for itemized deductions. That bill must still clear the Senate before being signed into law.

2. **<u>Trade or Business</u>.** Despite its prevalent use, neither the Code nor the Treasury Regulations define what constitutes a "trade or business". As such, the determination of whether an activity rises to the level of a trade or business has been left to the Courts.

a. ***<u>Groetzinger</u>* <u>Test</u>.** In *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987), the Supreme Court provided that in order to constitute a trade or business, "the taxpayer must be involved in the activity with continuity and regularity and … the taxpayer's primary purpose for engaging in the activity must be for income or profit."

b. **<u>For Profit Activity</u>.** The primary purpose of the taxpayer for the activity must be the pursuit of profit. *See Doggett v. Burnet*, 65 F.2d 191, 194 (D.C. Cir. 1933). Whether an activity is engaged in for profit does not turn on the reasonableness of the taxpayer's belief in the profitability of the activity, but rather on the honest, good faith efforts of the taxpayer. *See id.; Hillcone S.S. Co. v. Commissioner*, T.C. Memo. 1963-220.

i. **Good Faith Means More Than Mere Hope.** The taxpayer must have more than mere hope that the venture will prove profitable – the taxpayer should have a specific plan for achieving a profit. *See Sutherland v. Commissioner*, T.C. Memo. 1968-20; *Outten v. Commissioner*, T.C. Memo. 1984-81.

ii. **Section 183 Hobby Loss Profitability Test.** Section 183 provides expense deduction limitations for activities not engaged in for profit – *i.e.* hobbies. The application of Section 183 turns on whether the activity was engaged in for profit. Treas. Reg. § 1.183-2(b) provides a non-exclusive list of factors relevant to determine profit motive:

(1) ***The Manner in Which the Taxpayer Carries on the Activity.*** Evidence of a profit motive exists where the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records. Treas. Reg. § 1.183-2(b)(1). A profit motive is also evidenced by carrying on the activity in a manner substantially similar to other activities, changing operating methods, abandoning unprofitable methods, and adopting new techniques in a manner consistent with an intent to improve profitability. *Id. See also Yeager v. Commissioner*, T.C. Memo. 2002-9 (changing operational methods); *Abbene v. Commissioner*, T.C. Memo. 1998-330.

(2) ***The Expertise of the Taxpayer or His Advisors.*** Extensive preparation or consultation of expert advice related to accepted business, economic, and scientific practices relevant to the activity illustrate a profit motive. Treas. Reg. § 1.183-2(b)(2). However, proceeding in a manner inconsistent with those accepted practices and expert advice may indicate a lack of profit motive. *Id.*

(3) ***The Time and Effort Expended By the Taxpayer in Carrying on the Activity.*** The devotion of substantial personal time and effort in carrying on the activity evidences a profit motive, especially where the activity lacks personal or recreational aspects. Treas. Reg. § 1.183-2(b)(3). A lack of personal time and effort devotion can be overcome where the taxpayer employs competent and qualified persons to engage in the activity. *Id.*

(4) ***Expectation That Assets Used in Activity May Appreciate in Value.*** Profit, as used in this context, includes asset appreciation. A taxpayer may intend to earn a profit from the operations of the activity or from the appreciation in value of the underlying assets – such as land, buildings, etc. Treas. Reg. § 1.183-2(b)(4). Farming exception. Treas. Reg. § 1.183-1(d).

(5) ***Success of the Taxpayer in Carrying on Other Similar or Dissimilar Activities.*** The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable. Treas. Reg. § 1.183-2(b)(5).

(6) ***The Taxpayer's History of Income or Losses With Respect to the Activity.*** A series of years with net income is strong evidence of a profit motive. However, the existence of continued losses beyond the start-up stage (and during the time customarily expected to render an activity profitable) may indicate a lack of profit motive unless the taxpayer can explain the continued losses – *i.e.* natural disasters or other unforeseen circumstances. Treas. Reg. § 1.183-2(b)(6).

(7) ***The Amount of Occasional Profits, If Any, Which Are Earned.*** The relation of profits, if any, to the investment made in and losses incurred from an activity can evidence a profit motive or lack thereof. Profit motive is evidenced by substantial profits in relation to losses and the investment in the activity. Likewise, small profits in relation to a substantial investment or large losses represent a lack of profit motive. Treas. Reg. § 1.183-2(b)(7).

(8) ***The Financial Status of the Taxpayer.*** If the taxpayer lacks substantial outside income – sources other than the activity at issue – such lack of independent income will evidence a profit motive. Treas. Reg. § 1.183-2(b)(8).

(9) ***Elements of Personal Pleasure or Recreation.*** The presence of personal motives, especially where the activity has recreational or personal elements, can indicate a lack of profit motive. Treas. Reg. § 1.183-2(b)(9). However, an activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. *Id.* The fact that a taxpayer derives personal pleasure from engaging in the activity is not sufficient to deprive the activity of a profit motive. *Id.*

iii. **Initial Profitability.** A trade or business can exist without initial profitability as long as the potential for profit exists. *See Van Beuren v. Commissioner*, T.C. Memo. 1963-280; *Hill v. Commissioner*, T.C. Memo. 1971-127; *Ellsworth v. Commissioner,* T.C. Memo. 1962-32.

iv. **Non-Profit Activities.** Generally, non-profit activities (by virtue of their non-profit status) cannot satisfy the "for profit" requirement under Section 162. *See Iowa State Univ. Of Sci. & Tech. v. United States*, 500 F.2d 508 (Ct. Cl. 1974). This generally only matters in the context of unrelated business income taxable under Section 512. However, the Court of Claims opened the door for non-profit Section 162 deductions in *Trustees of the Graceland Cemetery Improvement Fund v. United States*, 515 F.2d 763, 778 (Ct. Cl. 1975) when it found that a perpetual care fund's payments to an associated cemetery corporation were deductible because the expenses were similar to those incurred by for-profit entities. *See also Cleveland Athletic*

Club, Inc. v. United States, 779 F.2d 1160, 1165 (6th Cir. 1985) (adopting an economic gain test for non-profit Section 162 expense deductions against unrelated business income similar to the test applied in *Graceland*).

c. **<u>Continuity and Regularity</u>.** There are no hard and fast rules for what constitutes continuous and regular activity. A survey of the case law suggests that the Courts are concerned only with whether the facts demonstrate an active, ongoing effort that satisfies the Court as to whether the taxpayer devotes full effort to the activity or merely engages in a part-time hobby.

i. ***Snell v. Commissioner*, 97 F.2d 891, 892-93 (5th Cir. 1938).** The Fifth Circuit perhaps best defines the continuity and regularity requirement:

> The word [business], notwithstanding disguise in spelling and pronunciation, means busyness; it implies that one is kept more or less busy, that the activity is an occupation. It need not be one's sole occupation, nor take all his time. It may be only seasonal, and not active the year round. It ordinarily is implied that one's own attention and effort are involved, but the maxim *qui facit per alium facit per se*[4] applies, and one may carry on a business through agents whom he supervises.

ii. **No Goods or Services Required.** Prior to the Supreme Court decision in *Groetzinger*, Courts often limited trades and businesses to those offering goods or services to others. *See, e.g.*, *Gajewski v. Commissioner*, 723 F.2d 1062 (2d Cir. 1983). In *Groetzinger*, the Supreme Court rejected that limitation and extended the trade or business designation for a taxpayer that spent 60-80 hours a week at the race track reviewing various materials before placing bets despite the fact that the taxpayer never made bets for anyone other than himself. 480 U.S. 23 (1987). There, the Court held that the taxpayer was engaged in the trade or business of gambling.

[4] The phrase is Latin for "He who acts through another does the act himself.

iii. **More than One Business.** Taxpayers may be engaged in more than one trade or business. *See Storey v. Commissioner*, T.C. Memo. 2012-115 (taxpayer was both a full-time partner in a law firm and engaged in a film production business). Of course, it is the taxpayer's burden to prove engagement in multiple businesses and, generally speaking, the more businesses a taxpayer is involved in, the less likely all of those activities will be treated as a trade or business. *See Beard v. Commissioner*, T.C. Memo. 1995-41 (governmental attorney did not pursue separate non-government attorney work with sufficient continuity and regularity to constitute a trade or business).

iv. **Unified Business Enterprise.** In *Morton v. United States*, 98 Fed. Cl. 596, 600-02 (2011), the Court of Federal Claims determined that a group of activities engaged in by the taxpayer constituted a "unified business enterprise" such that the taxpayer's ownership of an airplane in one entity was deemed to constitute a trade or business because it permitted the taxpayer to carry on his other trades or businesses. *See also Campbell v. Commissioner*, 868 F.2d 833, 836-37 (6th Cir. 1989). *But see Steinberger v. Commissioner*, T.C. Memo. 2016-104 (finding the unified business theory did not apply where taxpayer was not the majority shareholder of each entity).

3. **<u>Ordinary and Necessary</u>.**

a. **<u>Ordinary</u>.** The nature and scope of the business/activity in question define what is an ordinary expense. *See Anaheim Union Water Co. v. Commissioner*, 321 F.2d 253, 258 (9th Cir. 1963); *Deputy v. duPoint*, 308 U.S. 488 (1940). The question remains, whether a business/activity of the size and scope of the taxpayer's business/activity would ordinarily incur the expense in question. However, An expense may be ordinary even if the taxpayer is the only one in the industry who incurs that expense. *See United Title Ins. Co. v. Commissioner*, T.C. Memo. 1988-38.

b. **<u>Necessary</u>.** Similarly, an expense will be considered necessary if it is appropriate and helpful in developing and maintaining the taxpayer's business. *See Welch v. Helvering*, 290 U.S. 111 (1933). Necessary only imposes a minimal requirement; an expense is not rendered unnecessary merely because the same ends could be achieved by different means. *United Title Ins. Co. v. Commissioner*, T.C. Memo. 1988-38.

4. **<u>Carrying on a Trade or Business</u>.** The trade or business must have been open and active when the expense was incurred. Expenses incurred prior to the opening of the business will likely be treated as start-up expenses that must be capitalized and recovered through amortization. *See* Code § 195(a) and (b).

   a. **<u>Open for Business</u>.** A business is not open when it remains a mere expectation of the taxpayer. *See Ellis v. Commissioner*, T.C. Memo. 1967-94. A newly formed corporation is not open for business when it merely submits a proposal for a project but has no additional investors, income, plan, facilities, or contracts. *See Willits v. Commissioner*, T.C. Memo. 1999-230.

   b. **<u>Start Up Expenses</u>.** Section 195(c)(1) defines start-up expenses as those amounts paid or incurred in connection with (1) investigating the creation or acquisition of an active trade or business, (2) creating an active trade or business, or (3) any activity engaged in for profit. AND if such expenses were paid or incurred in connection with the operation of an existing active trade or business they would be allowable as a deduction. *See Jackson v. Commissioner*, 864 F.2d 1521 (10th Cir) (expenditures for acquisition of territorial sublicenses for product distribution were start-up expenses); *Juda v. Commissioner,* 90 T.C. 1263 (1988) (capitalize expenses paid to find investors for patents); *FMR Corp. v. Commissioner*, 110 T.C. 402 (1998) (expenses of investment management corporation in starting new regulated investment companies were nondeductible start-up expenses).

C. **<u>Section 212: Income Producing Activities (Prior to Jan 1, 2018)</u>.** If an activity does not constitute a trade or business, Section 212 provides a deduction for all ordinary and necessary expenses paid or incurred during the taxable year for (1) the production or collection of income; (2) the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.

   1. **<u>Production of Income: Proof Parallel to Section 162</u>.** Like Section 162 discussed above, in order to qualify for treatment under Section 212, the taxpayer must prove that the expense is "ordinary and necessary" and that the taxpayer possessed a profit motive for the activity. As discussed, a lack of profit motive by itself will reduce the taxpayer to seeking deductions to offset activity income under hobby loss rules of Section 183.

a. **Factors in Favor of Income Motive.** In conjunction with and addition to the profit motive factors of Treas. Reg. § 1.183-2(b), Courts have found an income motive in a variety of situations. *See, e.g.*, *Gorod v. Commissioner*, T.C. Memo. 1981-632 (advertising property for rent and expenditures to maintain property in income generating condition); *Nelson v. Commissioner*, T.C. Memo. 1978-287 (no or minimal personal use of property).

b. **Factors Against Income Motive.** Similarly, the Courts have found a variety of factors indicative of a lack of profit motive. *See Eisenstein v. Commissioner*, T.C. Memo. 1978-95 (charging rent at below fair market rates); *Hirschel v. Commissioner*, T.C. Memo. 1981-189 (failure to charge rent); *Bragg v. Commissioner*, T.C. Memo. 1993-479 (personal use of property); *Houle v. Commissioner*, T.C. Memo. 1985-389 (property not suitable for income generating activities).

2. **Property Held for Production of Income.** Property is considered held for the production of income if income is realized during the tax year, realized in a previous tax year, or may be realized in a subsequent tax year. Treas. Reg. § 1.212-1(b). Property can be held for the production of income, not just based on production of recurring income, but also if gain is produced by the disposition of the property. *Id.*; *Coors v. Commissioner*, 60 T.C. 368 (1973).

3. **Determination, Collection, or Refund of Any Tax.** Section 212 permits a deduction for expenses paid in a proceeding involving the determination, collection, or refund of any tax. This applies regardless of whether the taxing authority is federal, state, a municipality, or foreign country. *See* Treas. Reg. § 1.212-1(l); *Sharples v. United States*, 533 F.2d 550 (Ct. Cl. 1976). This applies to income, estate, gift, property, and any other tax. *See* Treas. Reg. § 1.212-1(l); *Farwell v. Commissioner*, 35 T.C. 454 (1960); *Coffey v. Commissioner*, 1 T.C. 579 (1943).

4. **Taxpayer Limitations.** Neither partnerships nor corporations can make use of the deduction under Section 212. *See* Code § 703(a)(2)(E) (denying partnership deductions under Section 212); *KWTX Broadcasting Co. v. Commissioner*, 31 T.C. 952, 957 (1959) (Section 212 does not apply to corporations because it only applies to individuals). Thus, for partnerships and corporations, failing the Section 162 trade or business qualification will result in non-deductibility of most expenses.

5. **<u>Pre-Opening Expenses</u>.** While there is no express "carrying on" requirement under Section 212 as with Section 162, expenses are not deductible under Section 212 if paid or incurred in preparing for the activity that would justify the deduction under Section 212. *See Sorrell v. Commissioner*, 882 F.2d 484 (11th Cir. 1989); *Lewis v. Commissioner*, 861 F.2d 1232 (10th Cir. 1988); *Hardy v. Commissioner*, 93 T.C. 684 (1989). These expenses will be treated as preparatory or start-up expenses which must be capitalized and amortized under Section 195.

6. **<u>It's All or Nothing for Most Taxpayers Now</u>.** As discussed, the Tax Cut and Jobs Act eliminated the deductions for Section 212 for profit activities and Section 183 hobby losses starting January 1, 2018.

D. **<u>Application of the Sections 162/212 Distinction in the Context of the Family Business</u>.** Generally, Courts will subject intra-family transactions to greater scrutiny. *See Estate of Bongard v. Commissioner*, 124 T.C. 95, 119 (2005). For such transactions, the question becomes whether a bona fide business relationship existed and whether the payment was made because of the familial relationship. *See Commissioner v. Culbertson*, 337 U.S. 733, 746 (1949).

1. **<u>*Higgins v. Commissioner*, 312 U.S. 212 (1941): Managing Your Own Investments Does Not Constitute a Trade or Business</u>.** In *Higgins*, the Supreme Court held that a taxpayer was not engaged in the trade or business of managing investments where he only managed his own investments for his own benefit. The taxpayer held extensive investments in real estate, bonds, and stock, devoted significant time to the oversight of those investments, and hired employees to manage both the real estate activities via renting buildings and his investments. The IRS disallowed the salaries and expenses reported by the taxpayer and related to the investment activity (but allowed those related to the real estate rental ventures). The Supreme Court held that the investment activities did not constitute a trade or business: "No matter how large or how continuous or extended the work required may be, such facts are not sufficient as a matter of law…" *Id.* at 218.

2. **<u>*United States v. Pyne*, 313 U.S. 127 (1941): Conserving a Business Is Not Carrying on a Business</u>.** Two months after its decision in *Higgins, supra*, the Supreme Court held in *Pyne* that executors of an estate who preserved the estate of a decedent as the decedent had when has was alive fell short of the definition of "carrying on a business." In *Pyne*, the decedent was a financier and investor who maintained an office and employed an officer manager and six clerks. After his death, the executors of his estate maintained the same office set-up to manage the decedent's estate which consisted of shares of stock, bond issues, and real estate. The executors employed an attorney to advise on legal and economic issues arising from the activities of the estate, federal tax consequences, and the disposition of the assets. The executors then deducted the fee paid to the

attorney on the income tax return of the estate. The Court of Claims, 92 Ct. Cl. 44 (1940), held that the estate was carrying on a trade or business by virtue of stepping into the shoes of the decedent. The Supreme Court vacated and remanded the Court of Claims decision holding "it cannot be said as a matter of law that an executor comes into [carrying on a business] merely because he conserves the estate by marshalling and gathering the assets as a mere conduit for ultimate distribution." *Id.* at 132. ***City Bank Farmers Trust Company v. Helvering*, 313 U.S. 121 (1941): Management of Trust Corpus Does Not Constitute Carrying on a Trade or Business.** At the same time it decided *Pyne*, the Supreme Court held in *City Bank* that the activities of a trustee in reviewing, selling, and reinvesting the proceeds of investments held in two trusts did not constitute the carrying on of a trade or business. Relying on *Higgins*, the Supreme Court found no difference between the activities of the taxpayer in *Higgins* and the trustee in *City Bank* – both of whom were managing and investing their own funds (despite the presence of the beneficiaries in *City Bank*). As such, the Supreme Court denied the trusts a deduction for the fee paid to the trustee for his services related to the management of the trusts.

4. ***Whipple v. Commissioner*, 373 U.S. 193 (1963): Devotion to a Business Is Not a Trade or Business.** In *Whipple*, twenty-two years after *Higgins*, the Supreme Court ruled that no matter how much time and effort an individual devotes to a corporation engaged in a trade or business, that individual is an investor and not engaged in a trade or business himself. *Id.* at 202. In *Whipple*, the taxpayer formed a series of partnerships and fifteen corporations, purchased a bottling corporation and root beer franchise, and acquired a vending machine business. When funds loaned by the taxpayer to the bottling franchise became worthless, the taxpayer was denied a deduction for a business bad debt. The Supreme Court, affirming the Tax Court and Fifth Circuit, held that "[d]evoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged." *Id.* at 202.

5. ***Beals v. Commissioner*, T.C. Memo. 1987-171: Using Your Business Experience For Your Personal Benefit Is Not a Trade or Business.** In *Beals*, the Tax Court held that a professional trader did not carry on a trade or business with respect to the management of investments owned by himself, his wife, and their three children. The taxpayer, a stock broker who formed and operated his own brokerage firm from 1938 to 1950 when he sold and dissolved the firm, and continued to operate under the name of stock brokerage firm through the late 1970s and 1980 (the years at issue) also managed investments of his family. The Tax Court held that "it is well settled that the management of investments, despite the extent and scope of such activities, is not a trade or business for tax purposes." In so doing, the Tax Court reiterated its distinction between an investor and a trader expressed in *Liang v. Commissioner*, 23 T.C. 1040, 1043 (1955):

> The distinction between an investment account and a trading account is that in the former, securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of the securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis.

According to the Tax Court, the activity of the family accounts resembled an investment account even though the taxpayer was actively involved in the investigation of the investments made by him and his family.

6. ***Dagres v. Commissioner*, 136 T.C. 263 (2011): A Business With An Investment Component Is Still a Business.**

a. In *Dagres*, the taxpayer plied his trade as a venture capitalist. He, along with some associated entities, formed a series of venture capital funds which sold limited partnership interests to investors constituting 99 percent of the venture capital fund. The taxpayer and his associates formed LLCs (of which only they were members) that owned the other 1 percent of the venture capital fund as the general partner and which were responsible for providing management and investment services. The LLCs in turn contracted with management companies that were run by the taxpayer and his associates for management and investment services. The LLCs, in addition to the 1 percent investment interest, were paid a 20 percent profit interest on the profits of the venture capital fund.

b. Along the way, the taxpayer incurred a bad debt loss related to the venture capital activities and the IRS disallowed the loss asserting that because the LLCs held a 1 percent investment interest in the venture capital fund they were managing their own money which did not constitute a trade or business.

c. The Tax Court rejected the IRS rationale and held that "the activity of "'promoting, organizing, financing, and/or dealing in corporations … for a fee or commission or with the immediate purpose of selling the corporations at a profit in the ordinary course of that business' is a business…". *Id.* at 281 (quoting *Deely v. Commissioner*, 73 T.C. 1081, 1093 (1980). The Tax Court found that the LLCs, as general partners of the venture capital funds, were in the business of managing those funds and they were compensated for those services by the 20 percent profits interest which served as a greater incentive to perform such services than the 1 percent investment interest. *Id.* at 283-86.

7. ***Lender Management, LLC v. Commissioner*, T.C. Memo. 2017-246: Who Says You Cannot Mix Business With Family?**

a. In *Lender Management*, the Tax Court applied the rationale of *Dagres* to funds managed by members of the Lender family for the benefit other members of the Lender family and found that the management of those funds constituted a trade or business under Section 162. During the tax years at issue, Lender Management was owned by two revocable trusts and managed investments for three limited liability companies (investment LLCs). Lender Management held an equity interest between 0.4% and 8.26% in the investment LLCs. At the same time, the two principals of the revocable trusts indirectly owned interests in the investment LLCs, never exceeding 11.5%. Lender Management, in addition to its direct and indirect equity ownership, was paid by the investment LLCs at various rates computed on the gross receipts and increase of net asset value ("profits interest"). All of the owners of Lender Management were members of the Lender family and investors in the investment LLCs, but not all of the investors were owners of Lender Management (though they were all members of the Lender family. The IRS disallowed losses reported by Lender Management on the theory that Lender Management was not engaged in a trade or business, but instead managed its own asset under Section 212.

b. The Tax Court rejected the IRS theory and found that Lender Management was engaged in the business of managing the investment LLCs despite the familial relationships of the management entity and the investment vehicles. The Tax Court held that "a common factor distinguishing the conduct of a trade or business from mere investment has been the receipt by the taxpayer of compensation other than the normal investor's return." The Tax Court went on to state that a trade or business exists even where the taxpayer invests his or her funds alongside those managed for others. The Tax Court based its findings on the fact that, as in *Dagres*, the profit interest granted to Lender Management was disproportionate and in addition to the equity interest, that most of the funds managed by Lender Management (91.74 to 99.6 percent) were not funds belonging to Lender management, that the family did not act with one mindset, the individual family members were entitled to withdraw funds as they chose, and that no attribution rules existed to treat Lender Management as if it was managing its own money.

c. Based on these facts, in addition to the active management services actually provided by Lender Management, and the lack of identity of ownership between Lender Management and its investment entities (as well as the fact that the Lender family had grown so large that parts of the family had never had any real interaction), the Tax Court held that Lender Management was engaged in a trade or business for purposes of Section 162 and permitted the ordinary business losses incurred by Lender Management.

II. THE MOST FREQUENT ESTATE & GIFT TAX DISPUTE: VALUATION. For family businesses, valuation remains one of the most common issues arising in the estate and gift tax arena (and even in the income tax arena). The close scrutiny given (or thrust upon) family businesses can lead to questions about the arm's length nature of any transaction – giving rise to potential gift tax consequences today and estate tax consequences later. For your anchor clients, it remains critically important that they understand the necessity for adequate valuations.

A. Valuations Increasingly Make the World Go Round.

1. Historic Overview. Although most commonly seen in the estate, gift, and charitable world, valuation increasingly injects itself into the realm of corporate tax planning as the living statutory standard preferred by Congress – a standard that theoretically captures "fairness" and changing economics.

2. Breadth of Cases Involving Valuation Disputes. Seventeen years ago, the Tax Court chronicled how far the tentacles of valuation reached even then:

> We approximate that ***243 Sections of the Code require fair market value*** estimates in order to assess tax liability, and that 15 million tax returns are filed each year on which taxpayers report an event involving a valuation-related issue. *Estate of Auker v. Commissioner*, T.C. Memo. 1998-185. (Emphasis added).

From Section 332 liquidations through 368 reorganizations to 362(e) loss importation and 382 NOL limitations, C corporations must now frequently deal with an explicit fair market value standard and the "experts" who determine it. Other common corporate contexts like Section 482 pricing, Section 1060 purchase price allocation, and every reasonable compensation inquiry all invoke arm's length valuation concepts – and criticisms. Nearly every provision (and issue) arising from the gift and estate tax regime requires some level of or reference to valuation.

B. <u>The Two Most Critical Components of Your Case: The Expert Witness and the Expert Report</u>.

1. **<u>Most Common Myths About Appraisals and Appraisers</u>.** Management, clients, planners, and the transactional world subscribe to certain myths about valuation – myths that lead to frustration, anger, and disappointment.

> Myth #1 – Correct valuations exist and foreclose future debate.
>
> Myth #2 – A fixed fee on an appraisal is a good idea, and negotiating it down is an even better idea.
>
> Myth #3 – The appraiser is an expert better left to his or her own expertise and devices – after all, she's the expert.
>
> Myth #4 – Let's get that final report to the IRS ASAP. No one needs to see and comment on a draft before the expert reaches her final conclusion – why that would be inappropriate.
>
> Myth #5 – Let's make sure we document all our communications with the expert through emails – better yet, unprivileged emails.

2. **<u>Selecting Experts</u>.** All of these points need to be covered before you get to how quickly, how much, and how do we work with her on getting her the facts.

   a. **<u>Google the Issue and the Expert</u>.** If you are still nervous, conduct a public record search for lawsuits, tax liens, and criminal record – the same search you will do on your adversary's expert.

   b. **<u>Credentials</u>.** Credentials constitute the essential ticket to the game but, beyond admission, carry very little weight. *St. Martin v. Mobil Exploration & Producing U.S., Inc.*, 224 F.3d 402 (5th Cir. 2000).

   c. **<u>Special Expertise in That Industry or Market</u>.** The ability to cast your expert as the "go to" guy or gal in that specific area presents your first chance to pass your adversary. Jacks-of-All-Trades can be drawn into the specific area and forced to admit they lack the depth of your superhero.

d. **<u>Health, Age, and Personal Problems</u>.** Will the candidate be available if the issue gets pressed to trial – generally ten years after the fact for large cases? Any divorce, alcohol, or similar distractions?

e. **<u>Likeable</u>?** Counter-intuitive as it may seem, the antithesis of credibility is not lack of credibility: it is arrogance. Also, is the candidate obsequious on the one hand or combative on the other?

f. **<u>Quality, Depth, and Fact Specific Reports</u>.** Ask for client sanitized versions of the last three reports addressing your type of problem – valuation of a parathinic refinery, mixed pine/hardwood timberlands in middle Georgia, **etc.** Keep in mind that, if you do not settle the case, the contemporaneous report will not be admissible in Tax Court unless it meets TAX COURT RULE 143(g). Also consider trial/Appeals graphics.

g. **<u>Is the Candidate a Professional Witness or a Professional Expert</u>?** Like political and Supreme Court candidates, sometimes the lack of a record can be an asset. In all events, you need to plumb the track record for exposure as to reliability or conclusions or methodologies that contradict the conclusion you seek.

h. **<u>Do Real People Rely on the Expert's Opinions to Make Real Decisions</u>?** Because reality adds credibility to opinions, you want to be able to stress that the opinion the expert offers here follows the same methodology, analysis, and conclusion she follows in advising real business people, governments, etc., to make huge decisions.

i. **<u>Too Flexible or Inflexible</u>?** Witnesses who are too malleable get lignified on cross-examination. So too, witnesses who are too inflexible are dangerous at every level. Due either to a lack of intelligence or hypersensitivity to adjusting opinions, an inflexible witness will not consider any new thoughts or facts you offer and will lose credibility when he refuses to adjust his opinion in light of new thoughts or facts your adversary presents.

j. **"<u>If You Were Cross-Examining You, What Are the Most Damaging Questions You Could Pursue</u>?"** A competent candidate knows his tender underbelly. This question will either reveal his exposure or the more important point – can you trust him to be honest with you?

3. **Get the Best Report Possible.**

a. **Tailor the Report.** Pay attention to your audience, especially whether your case will involve a jury, a District Court judge, or a Tax Court judge. Don't make it easy on yourself – canned gets you canned.

b. **Include Trial Charts in the Report.** You want the reader to easily understand your materials in a short amount of time.

c. **Do Not Write Anything You Do Not Want Disclosed.** While drafts are not discoverable, facts are. All communications with experts must be written with an eye towards discovery. *See* TAX COURT RULE 70(c)(4).

d. **Make the Report Realistic.** Whenever possible, tie the report to practical reality. Analyze the due diligence inquiry by prospective buyer and perform a business risk analysis. If it does not make common sense to someone halfway through Economics 101 in terms an 8th grader can understand, rewrite it. Do not confuse the hypothetical buyer and seller with imaginary/hypothetical sale that defies reality. The hypothetical buyer and seller are not strategic buyers and sellers. They are, however, subject to contractual and legal constraints and clouds on title.

e. **Weigh Your Options and Exercise Judgment.** Make decisions based on what you think is right, and do not abdicate judgment in favor of opposing party just "to be conservative."

f. **Consult All Available Sources and Consider All Available Information.** Interview realtors, bankers, zoning offices, etc. The expert is a factual witness – so the report need not cite cases, rulings, or legal treatises unless the valuation treatises provide valuation principles. In addition, ask for all pleadings, documents, discovery, past and current appraisals – FROM BOTH SIDES.

g. **Review, Review, and Review Again.** If the expert's report is sloppy, so is your case. Do not delegate all responsibility. Check and recheck all of the numbers and text.

h. **The Devil Is in the Details.** Spend more time defining property interest. The appraisal most closely tied to the peculiar facts of the company or property generally wins.

i. **How Would You Attack Your Expert's Report?** Analyze your expert's report from your opponent's point of view. Be cognizant of any potential *Daubert* attacks.

j. **<u>The Expert's Opinion Needs to Be the Same Regardless of His Employer</u>.** The expert must have the same opinion whether he represents the plaintiffs or the defendant; the buyer or the seller; or government or citizens. The expert must remain neutral in his report, and pay careful attention not to be a cheerleader/advocate, or to sound like a lawyer.

k. **<u>Avoid Hindsight</u>.** Peaking behind the current at subsequent events unknown to the hypothetical buyer and seller on the actual valuation date is at most permitted where foreseeable AND where circumstances have not changed in the interim.

l. **<u>Above All Else, Stress Accuracy</u>.**

C. <u>What's Fair About the Value</u>?

1. **<u>Defining "Fair Market Value</u>".** Fair market value can differ from the standard of fair value sometimes used in securities or financial accounting standards.

a. **<u>Elements</u>.** Broken into its slightly expanded elements, fair market value means:

- The price in cash or its current equivalent,
- That an arm's length buyer would pay,
- An arm's length seller,
- On the valuation date (based on what was known, knowable, or anticipated on that date),
- For the subject property interest with all its attributes, restrictions, etc. (the most common point of error and dispute),
- With both the buyer and seller being reasonably knowledgeable of all relevant facts, and
- Neither the buyer nor the seller acting under any form of compulsion (or other non-market force).

See, e.g., United States v. Cartwright, 411 U.S. 546, 551 (1973); Treas. Reg. § 20.2031-1.

b. **<u>State Law</u>.** State law defines the property interest, while federal law defines the tax consequences of those property interests. *Morgan v. Commissioner*, 309 U.S. 78, 82 (1940).

c. **<u>Objective Test</u>.** The standard is an objective test using hypothetical buyers and sellers in the marketplace, not a personalized test that envisions a particular buyer and seller.

2. **<u>Determining Fair Market Value</u>.** In determining fair market value of an entity or asset, it is important to consider (a) the individual characteristics of the subject entity or asset, (b) all relevant methodologies, and (c) all relevant data.

a. **<u>Methodologies</u>.** The three basic methods for determining fair market value are: (a) the market approach, (b) the asset/cost approach, and (c) the income approach.

i. **Market Approach.** The market approach involves a comparison of the business to be valued to the prices at which similar businesses or business interests change hands. Generally, there are two methods used in market approach: 1) the guideline publicly traded company approach; and 2) the guideline transaction method. Rev. Rul. 59-60 places an emphasis on the market method stating:

> As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflects the consensus of the investing public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value muse be used. In many instances, the next best measure may be found in the prices at which the stocks of companies engaged in the same or a similar line of business are selling in a free and open market.

(1) ***Guideline Publicly Traded Company Method.*** The guideline publicly traded company method consists of determining the price of the subject company in comparison to underlying financial data from day-to-day publicly traded companies. An appraiser develops valuation multiples based on market prices for the guideline companies and their underlying financial data. The appraiser then applies the valuation multiples to the subject company's financial data to arrive at a value.

(2) ***Guideline Transaction (Mergers and Acquisition) Method.*** The guideline transaction method consists of comparing prices of comparable transactions to the underlying financial data of the subject company. With this method, an appraiser creates value estimates by analyzing the underlying financial information from completed transactions. An appraiser attempts to locate completed transactions of companies similar to the subject company. The appraiser then applies the valuation multiples to the subject company's financial data to arrive at an estimate of value.

(3) ***Other Factors to Consider.*** An appraiser would want to make different adjustments to make the proposed comparable company more comparable to the subject company by adjusting for such things as leverage, market share, size, deal terms, and the relevance of the multiple to the subject company. In considering the market approach, an appraiser would also want to consider past transactions in the subject company, bona-fide offers to buy the subject company, and industry rules of the thumb.

ii. **Asset or Cost Approach.** The asset approach is based on the aggregate value of the underlying assets. An appraiser would restate the business's assets to their current appraised value less existing liabilities. Appraisers and courts rarely place heavy emphasis on this method in a business valuation context outside of holding companies or asset-heavy industries like financial institutions and natural resource companies.

iii. **Income or Cash-Flow Approach.** Under the income approach, an appraiser estimates the subject company's value based on the ability of its operations to generate income. This estimate can be calculated by using the discounted cash flows method, the capitalized of earnings method, or capitalization of dividends. Many corporate finance texts believe that the discounted cash flows method presents the best measure of value as it measures the value of future benefits to the owners discounted back to the present.

(1) ***Capitalization of Earnings*.** Under this method, an appraiser estimates a normalized measure of earnings, such as operating cash flow. This measure of earnings will be divided by the capitalization rate, usually the appropriate cost of capital less the projected growth in operating cash flow. Many prognosticators believe this to be a less reliable method of valuation than the discounted cash flow measure because it will be based on a single earnings base. However, the capitalization of earnings and the discounted cash flow method should yield similar results when the subject company is mature and future results will not deviate materially from past results.

(2) ***Capitalization of Dividends*.** This method involves capitalizing dividends at a rate consistent with the risk of the dividend-income stream. This method is most applicable when dividends are predictable, as in the case of a large public corporation, public utility, real estate investment trust, or a preferred stock. The indicated dividend yield is also a relevant factor in the valuation of closely held securities because the investor does not have the same opportunity to sell his interest in the market and derive a return on his investment through a capital gain as in the case of public-company investments. The capitalized-dividends method is most frequently used in determining the fair market value of fixed-income securities.

(3) ***Discounted Cash Flow*.** This method applies a discount factor to the projected cash flow of future periods. This method is often used as a primary index in instances where the future cash flow stream can be forecast with confidence such as in the case of certain types of income producing real estate and natural-resource-income properties. This method also plays an important role in situations in which historical financial performance is absent or not representative of future potential and in which asset values are negligible or not particularly meaningful. Typically, the discounted future cash flow method requires that the income statement be projected for several years into the future and that the projected income stream be adjusted for the following items: (1) projected cash outlays or investments required

to support projected income but not included in its calculation (such as capital expenditures and investments in working capital) and (2) non-cash expenditures included in projected income (such as depreciation and amortization).

iv. **Hybrid.** In the valuation of business interests, appraisers generally couple DCF with guideline company analysis for a hybrid Income/Comparable method.

b. **Individual Characteristics.** The appraiser must determine exactly what he is valuing. "One of the key considerations to valuing an FLP interest is a thorough understanding of the provisions of the partnership agreement to accurately reflect them in the value estimate." JAMES R. HITCHNER, FINANCIAL VALUATION APPLICATION AND MODELS (2nd ed. 2006), p. 698.

3. **Strategic Buyers and Sellers Must Be Disregarded.** The hypothetical aspect of the FMV buyer and seller bars consideration of the idiosyncrasies of a specific buyer or seller. *Estate of Jameson v. Commissioner*, 267 F.3d 366, 371-2 (5th Cir. 2001) (the Tax Court "should not have assumed the existence of a strategic buyer of the Timber Property"); *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 217 (1990).

4. **No Aggregation.** For the same reasons, determination of the fair market value cannot presume aggregation, and each separate gift or property must be measured on its own merits. *Estate of Bright v. Commissioner*, 658 F.2d 999, 1005-6 (5th Cir. 1981); Rev. Rul. 93-12, 1993-1 C.B. 202.

5. **The Key to Winning: ALL RELEVANT FACTS.** No greater opportunity exists for your appraiser to beat their appraiser than the simple requirement that the appraiser consider ALL RELEVANT FACTS. *See, e.g.*, *United States v. Cartwright*, 411 U.S. 546, 551 (1973); Treas. Reg. §§ 20.2031-1(b) and 25.2512-1 ("both [buyer and seller] having reasonable knowledge of relevant facts"); Rev. Rul. 59-60, 1959-1 C.B. 237. Especially on closely-held company valuation cases, no excuse exists for your appraiser to miss "all relevant facts" (that tell your story) and the opposing appraiser to consider all those facts – unless you educate the opposing appraiser.

D. <u>Valuation of Selected Entities and Assets</u>.

1. <u>Operating Subsidiaries and Other Closely Held Companies</u>.

a. <u>Purpose for Valuation</u>.

i. Gift, Bequest, Sale, or Purchase of a Business Interest.

(1) ***Define the Asset – The Most Common Problem*.**

(2) ***Allocation of Sale or Purchase Price*.** Valuations are used in determining the price to be paid for the assets of a going concern, or interest in a business. The valuation affects the bargaining power of each party in negotiations.

(3) ***Determinations of Tax Liabilities When Price Is Paid in Property*.** In addition to gauging the built-in tax on purchased assets, the parties must value any property conveyed as part of the sales price. The gain or loss on the property is equal to the "amount realized" less the basis the taxpayer has in the property exchanged. Code § 1001(a). The amount realized from the sale is the amount of money received (sale price) plus the fair market value of property, other than money, that was received. Code § 1001(b).

(4) ***Taxable Asset Sales*.** Within various categories, the law allocates consideration in a taxable asset sale among the assets based on their relative values. *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945). *Cf.* Treas. Reg. § 1.338-6. In order to properly make this determination, a valuation of each asset must be made in order to determine its value in relation to the value of the other assets. When the transferee and transferor agree to the allocation of consideration or the fair market value of the assets in an applicable asset acquisition, the agreement is generally binding on both parties under Section 1060(a). That follows the traditional *Danielson* rule that the courts defer to a contractual agreement between arm's length parties with adverse tax interests. *See, e.g., Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967); *Liquid Air Corp. v. Commissioner*, T.C. Memo. 1995-606; *Seas Shipping Co. v. Commissioner*, 371 F.2d 528 (2d Cir. 1967); *Ullman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959).

ii. **Gift of Interest in Family Limited Partnership or Other Investment Business Entity.** If an owner of a business entity, *i.e.*, a shareholder, member, or partner, makes a gift of all or a part of his or her interest in the business entity, that gift must be valued in order to determine the gift tax liability for such transfer.

iii. **Incorporation/Organization.** The determination of the fair market value of property contributed to a business entity affects the ownership interest of each shareholder or member who makes the capital contribution.

iv. **Tax-Free Reorganizations.** The valuations in these reorganizations may prevent the transaction from qualifying as a reorganization, or the distributions in connection with the transaction may alter tax consequences of the reorganization. The Service has required under certain types of reorganization that 70 percent of the gross assets and 90 percent of the net assets must be transferred. Rev. Proc. 77-37, 1977-2 C.B. 586. As a result, valuing the assets and determining that these percentages are being met is key. There are also a number of rules under the Treasury Regulations to Section 358 regarding the allocation of basis among the stock, securities, and other property received in a reorganization. Treas. Reg. § 1.358-2(a)(2)(i).

v. **Partnership Formation and Capital Account Maintenance.** A partner's capital account is used to determine the allocations of the partnership income, gain, loss, deduction, or credit under Section 704. The partner's capital account will be increased by the fair market value of all property contributed by that partner to the partnership and decreased by the fair market value of all property distributed to that partner. Treas. Reg. § 1.704-1(b)(2)(iv)(b). The determination of the fair market value of this property has a direct effect on the tax liabilities of the individual partner, as well as general liabilities and distributions received, in relation to the other partners in the partnership.

vi. **Restrictive Covenants.** A restrictive covenant, such as a Shareholder's Agreement, can operate to set the price of stock in a closely held corporation. However, the restrictive covenant must meet certain criteria for the Service to accept the price set in the agreement. When valuing stock of a closely held corporation with a restrictive covenant in place, it is necessary to evaluate whether that restrictive covenant operates to set the price of the stock under applicable law or whether the business entity should be valued without regard to the restrictive covenant. Section 2703(a) provides the general rule that the value of any property shall be determined without regard to any option, agreement, or other right to acquire or use the property at less than fair market value; or any restriction on the right to sell or use the property. For instance, a below market rate lease on real property would not be taken into account for valuation purposes. However, an option, right, agreement, or restriction may be taken into account for valuation purposes where: (1) it is a *bona fide* business arrangement; (2) it is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth; and (3) its terms are comparable to similar arrangements entered into by persons in an arm's length transaction. Code § 2703(b); Treas. Reg. § 25.2703-1(b)(1)(ii).

Additionally, Courts have held that a restrictive covenant must also meet the pre-2703 requirements to qualify, including (1) the offering price must be fixed and determinable under the agreement, (2) the agreement must be binding on the parties during life and after death, and (3) the agreement must have been entered into a for a *bona fide* business reason, not as a substitute for a testamentary disposition. *Estate of Lauder v. Commissioner*, T.C. Memo. 1992-736. Several Courts have addressed the application of Section 2703 to shareholders agreements. For the business purpose prong, Courts and the Joint Committee on Taxation note that transfer of stock in order to maintain exclusive family ownership and control serve a bona-fide business purpose. *See Holman v. Commissioner*, 601 F.3d 763, 770 (8th Cir. 2010); STAFF OF JOINT COMM. ON TAXATION, 101ST CONG. FEDERAL TRANSFER TAX CONSEQUENCES OF ESTATE FREEZES 14 (Comm. Print 1990).

For the device test, the regulations have expanded the application of Section 2703(b) from decedents (as stated in the statute) to the natural objects of the transferors bounty. Therefore, the Service argues that the test should apply to both *inter vivos* transfers and transfers at death. Whether a restrictive covenant constitutes a testamentary device depends on the fairness of the consideration received by the transferor, judged at the time the agreement is entered. *Estate of Amile v. Commissioner*, T.C. Memo. 2006-76, at *12. Although an opportunity exists to challenge the Service's expanded definition set forth in the regulation, given the Supreme Court's holding in *Mayo Foundation v. United States*, 131 S. Ct. 704 (2011), taxpayers should account for the device test for *inter vivos* gifts and testamentary transfers.

For the third prong, the regulations note that a right or restriction will be considered comparable to an arrangement entered into by persons in an arm's length transaction where the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business, dealing with each other at arm's length. Treas. Reg. § 25.2703-1(b)(4). This determination will consider the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term, and the adequacy of consideration given in exchange for the rights granted. *Id.*

In *Estate of Amile*, T.C. Memo. 2006-76, the IRS asserted a deficiency as it ignored the price set in an agreement which restricted the transfer. The Court held that the agreement met all the requirements of Section 2703 and controlled for estate tax purposes. *Cf Holman v. Commissioner*, 130 T.C. 170 (2008), *aff'd* 601 F.3d 763 (8th Cir. 2010) (Court ignored transfer restrictions in partnership agreement in determining gift tax values because transfer restrictions on partnership shares were not part of a *bona fide* business arrangement because there was no underlying business)

b. **Business Enterprise Value.** The Internal Revenue Service issued Rev. Rul. 59-60, 1956-1 C.B. 250 to set forth a general approach for valuing stock of a closely held corporation. The Ruling provides an in depth discussion of the following eight fundamental factors that should be considered by the appraiser:

i. **History of Enterprise.** The history of the operations of the company from inception can be very helpful in determining value. Specifically, some factors to consider are growth of the company, income and dividend history, diversification history, management history, and sales records.

ii. **Economic Outlook.** The appraiser should consider the current economic outlook, as the value of an interest in property shifts with changes in the economy.

iii. **Financial Condition.** The appraiser should examine the company's assets, liabilities, liquidity, capital structure and net worth.

iv. **Earning Capacity.** The appraiser should consider the company's historical earnings, as well as the future prospect of earnings.

v. **Dividend Paying Capacity.** When considering dividends, the dividend paying capacity tends to be more important than dividend payment history, as value is dependent on future returns.

vi. **Intangibles.** The appraiser should evaluate the goodwill, or reputation, and other intangible assets in determining value.

vii. **Past Sales.** If there are any previous arm's length sales of the subject company interests, the appraiser should contemplate the sale price utilized. *Sheedy v. Commissioner*, T.C. Memo. 2012-69.

viii. **Publicly Traded Companies.** The appraiser should consider the market price of similar publicly traded companies. The Ruling cautions that only comparable companies should be taken into consideration. In determining whether or not the publicly traded company is comparable, the appraiser should consider the following characteristics of the company:

(1) ***Industry*** **–** Companies in the same industry tend to have the same economic and industry influences.

(2) ***Size*** **–** This can be evaluated in terms of market capitalization, sales, or assets.

(3) ***Growth*** **–** Expected growth of a company correlates with its value.

(4) ***Financial Ratios*** **–** Profit margins, asset ratios, and inventory turnover are among the financials that should be examined. The four most common measures of profitability are: (a) Earnings before interest, taxes, depreciation and amortization ("EBITDA"), (b) Earnings before interest and taxes ("EBIT"), (c) Net income, and (d) Cash flow. EBIT and EBITDA tend to portray the economics of the business best. JAMES R. HITCHNER, FINANCIAL VALUATION APPLICATION AND MODELS (2nd ed. 2006), p. 288.

(5) ***Holding Company Versus Operating Company*** **–** When valuing a holding company, the appraiser affords greater weight to the assets of the company, whereas the appraiser affords greater weight to earnings when valuing an operating company.

c. **Adjustments.** The value of an interest in a privately held company is not directly comparable to the value of similar publicly traded interest because privately held companies and minority interests in those companies are not actively traded on the stock exchange as are shares of publicly traded companies. Therefore, the fair market value of an interest in a private company is adjusted to reflect its lack of liquidity and lack of a ready market. *Estate of Newhouse v. Commissioner*, *supra*. Additional adjustments may be warranted for built-in capital gains, large blocks of property, multiple tier companies, and key persons.

i. **Lack of Control.** The lack of control discount reflects the fact that the owner of an interest that is less than a majority does not have control over the decisions regarding management, investments, distributions, etc. Two major bodies of empirical evidence are often used to determine lack of control discounts: (1) prices at which controlling interests are acquired in the public market compared with the preannouncement minority stock trading prices (Mergerstat/Shannon Pratt Control Premium Study), and (2) prices at which holding company interests sell compared with their underlying net asset values (Real estate investment trusts, SEC-registered limited partnership interests, and closed-end mutual funds). SHANNON P. PRATT, BUSINESS VALUATION DISCOUNTS AND PREMIUMS (2nd ed. 2009), p. 66.

ii. **Lack of Marketability.** The lack of marketability discount reflects the fact that there is not a ready market available for the sale of a closely held entity. The empirical evidence used to determine discounts for lack of marketability include restricted stock studies and pre-IPO studies. In using the restricted stock and pre-IPO databases, it is important to select companies having characteristics similar to the subject company, and to make adjustments for differences in characteristics. *See, e.g.*, *Pierre v. Commissioner*, T.C. Memo. 2010-106 (The Court evaluated discounts for lack of control and lack of marketability and considered the impact of SEC Rule 144A restricted stock studies).

iii. **Discounts Related to Capital Gains.** In *Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998), the Appeals Court reversed the Tax Court for failing to consider the built-in capital gains taxes in determining value. In *Estate of Litchfield v. Commissioner*, T.C. Memo. 2009-21 (2009) the Court accepted the expert's built-in capital gains taxes discounts. Finally, in *Estate of Jensen v. Commissioner*, T.C. Memo. 2010-182, the Court addressed discounts for unrealized capital gains tax liability in valuing an interest in a C Corporation. The Tax Court allowed taxpayer's built-in, long term capital gains tax to be deducted in valuing the corporate assets.

iv. **Blockage Discount.** Considering the basic economic law of supply and demand, it tells us that if a large quantity of something is added to the existing supply, the price will tend to go down. Thus, large quantities may have a value lower than the sum of the prices of individual assets that make up the block. JOHN A. BOGDANSKI, FEDERAL TAX VALUATION, 4.02 Blockage, 1998 WL 1038939 (RIA/WG&L) (2011).

v. **Multiple Tier Valuation Discounts.** Where a taxpayer holds an interest in an entity that holds an interest in another entity, two layers (or tiered) discounts may be permitted. The courts have accepted the tiered discount where a taxpayer holds a minority interest in an entity that holds a minority interest in another entity. *Astleford v. Commissioner*, T.C. Memo. 2008-128. The courts have rejected the tiered discount where the lower level interest constituted a significant portion of the parent entity's assets, *Martin v. Commissioner*, T.C. Memo. 1985-424.

vi. **Key Person Discount.** In *Estate of Mitchell v. Commissioner*, T.C. Memo. 2002-98, the Tax Court provided for a 10 percent discount to the enterprise value for the loss of a key manager. In *Furman v. Commissioner*, T.C. Memo. 1998-157, one person played a key role in the management and operation of the subject company, and the Court found that a 10 percent key person discount was applicable to the interests in the stock. In *Estate of Feldmar v. Commissioner*, T.C. Memo. 1988-429, the Tax Court applied a 35 percent key employee discount, noting that the company was substantially dependent upon the services of one person, that person was driving force behind the company, and the company's existing management could not effectively replace the key employee.

2. **<u>Valuation of S Corporation Stock: Tax-Affecting</u>.**

a. **<u>The Gift That Keeps on Giving</u>.** The gift or devise of closely-held stock presents a multitude of valuation issues from valuation premise (going concern versus liquidation) to the appropriate method (earnings, assets, or some combination thereof), and the propriety of discounts for lack of marketability, lack of control, *etc.*

b. **<u>To Tax-Affect or Not to Tax-Affect: That Is The Question</u>.** One area of debate in recent years has been whether to "tax-affect" S corporation stock. Tax-affecting recognizes that C corporation earnings represent pre-tax dollars that must be converted to after-tax earnings for comparison purposes. Simply put, the value of a C corporation's earnings is discounted to reflect the reality that those earnings will be taxed before they reach the shareholder (decreasing their value to said shareholder).

i. **Continuing War.** Early on, the Tax Court recognized that valuation of an interest in an S Corporation should be "tax-affected" to put those earnings on the same plain as C Corporation earnings, as well as recognizing limitations on qualified S Corporation buyers and capital. *See Maris v. Commissioner*, T.C. Memo. 1980-444, *and Estate of Hall v. Commissioner*, T.C. Memo. 1975-141. Then the Tax Court reversed field in *Gross*, which the Sixth Circuit affirmed. *Gross v. Commissioner*, T.C. Memo. 1999-254, aff'd 272 F.3d 333 (6th Cir. 2001). The Tax Court has continued to resist tax-affecting S Corporation earnings. *See Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148; *Dallas v. Commissioner*, T.C. Memo. 2006-212; *Wall v. Commissioner*, T.C. Memo. 2001-75; *Estate of Adams v. Commissioner*, T.C. Memo. 2002-80. In the meantime, the

Delaware Chancery Court, perhaps the leading corporate forum in the country, applied S Corporation tax-affecting in *Delaware Open MRI Radiology Associates P.A. v. Kessler*, Del. Chan. Ct. (April 26, 2006). As a whole, the appraisal community believes tax-affecting S Corporation earnings remains essential. The curable complaint by the Tax Court is lack of market evidence.

ii. **Methods To the Madness.** The business valuation community has developed two different methods for addressing the issue of tax-affecting S corporation stock: the Delaware Chancery Court method and the S Corporation Economic Adjustment Method ("SEAM").

(1) ***The Delaware Chancery Court Method.*** The Delaware Chancery Court method stems from *Delaware Open MRI Radiology Associates, P.A. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006). In *Kessler*, the Delaware Chancery Court developed a method for valuing S corporation stock that compared the after-tax shareholder income of $100 in earnings if the S corporation were a C corporation versus its status as an S corporation. The following chart will help illustrate:

	C Corp	S Corp	S Corp Valuation
Taxable Income (TI)	$100	$100	$100
Corporate Tax Rate (R)	40%	0	**29.40%**
Available Earnings (AE)	$60	100	$70.60
Dividend or Personal Income Tax Rate (CGR)	15%	40%	15%
Net Income (NI)	$51	$60	$60

The approach determines the net income from the S corporation ($60) and then reverses the typical calculation using the dividend rate to determine the effective corporate rate it would take to reach the same net income. So the net income ($60) is divided by the inverse dividend rate (1 - 15 percent or 85 percent). This results in Available Earnings of approximately $70.60. The $70.60 is 70.6 percent of $100. The inverse of this percentage is the corporate rate needed to reach $70.60. Thus, the hypothetical corporate rate is 29.4 percent. The Kessler court treated this 29.4 percent as the appropriate rate to tax-affect the S corporation stock.

(2) ***The SEAM Approach***. The SEAM approach is perhaps the better of the two approaches because it strikes a balance by tax-affecting the S corporation stock but then adds back a premium for the fact that S corporation stock is only subject to one layer of taxation.

3. **IRS "Lack of Marketability Job Aid".** In August of 2011, the IRS released to the public a 107-page document entitled "Discount for Lack of Marketability Job Aid for IRS Valuation Professionals," summarizing and evaluating most of the methods currently in use for determining a Discount for Lack of Marketability.

a. **IRS General Attitude Toward Disallowance of Discount for Lack of Marketability.** The IRS disclosed its evaluation and recommendation for approaching the marketability discount as a valuator as the following:

> If you are approaching the question of DLOM fresh, either as a reviewer confronted with an unreasonable taxpayer position based on invalid approaches or as a valuator charged with making your own valuation discount decisions, it is often helpful to start with a basic question as relates to DLOM. That question is: "Under the prevailing facts and circumstances and considering the nature of the interest to be valued *why is the DLOM not zero?*" (Emphasis added).

b. **Factors Affecting Marketability of the Subject Company:**

(1) Value of subject corporation's privately-traded securities versus its publicly-traded securities (or, if the subject corporation does not have stock that is traded both publicly and privately, the cost of a similar corporation's public and private stock);

(2) Dividend-paying (or distribution) ability and history;

(3) Dividend yield;

(4) Attractiveness of subject business;

(5) Attractiveness of subject industry;

(6) Prospects for a sale or public offering of the company;

(7) Number of identifiable buyers;

(8) Attributes of controlling shareholder, if any;

(9) Availability of access to information or reliability of that information; management;

(10) Earnings levels;

(11) Revenue levels;

(12) Book to market value ratios;

(13) Information requirements;

(14) Ownership concentration effects;

(15) Financial condition;

(16) Percent of shares held by insiders;

(17) Percent of shares held by institutions;

(18) Percent of independent directors;

(19) Listing on a major exchange;

(20) Active v. passive investors;

(21) Registration costs;

(22) Availability of hedging opportunities;

(23) Market capitalization rate; or

(24) Business risk.

c. **<u>Factors Affecting Marketability of the Subject Interest</u>**:

(1) Restrictive transfer provisions;

(2) Length of the restriction period;

(3) Length of expected holding period;

(4) Offering size as a percent of total shares outstanding;

(5) Registered v. unregistered;

(6) General economic conditions;

(7) Prevailing stock market conditions; and

(8) Volatility of stock.

d. **<u>The IRS Instructs Its Agents to Request Certain Items During Audits Involving a Discount for Lack of Marketability and Discloses How Those Items Affect the Discount</u>.** The recently released IRS guidelines provide this list of requested information:

> The evaluation of the appropriateness of a discount for lack of marketability requires the collection and analysis of a substantial amount of information about the entity involved and the subject interest in that entity whose marketability is being considered. We provide below a list of typical inquiry areas that can be put forth in Information Document Requests toward the end of collecting such information. The bracketed notes below each item offer commentary about that item's relevance in evaluating its contribution to the lack of marketability and/or lack of liquidity determination:

- History of dividend payments [cash dividends are a "liquid" return on investment, which might lower lack of marketability risk];

- Salaries and bonuses paid to the Officers of the company, over the five years leading up to the valuation date [especially in companies that don't pay dividends, Officers' compensation can provide cash flow to shareholders, which might lower lack of marketability risk];

- Compensation and/or fees paid to the Directors of the company, over the five years leading up to the valuation date [especially in companies that don't pay dividends, Directors' fees can provide cash flow to shareholders, which might lower lack of marketability risk];

- List of all marketable securities (description, number, cost value) shown on the latest financial statements [cash-equivalent securities might lower liquidity risk on a company-wide basis];

- List of all non-marketable securities and investments (description, number, cost value) shown on the latest financial statements [can provide information on how long it might take to liquidate non-marketable assets];

- Breakdown of adjusted cost basis for each of the marketable and Nonmarketable assets owned by the company on the valuation date [can provide information on built-in capital gains tax expense to liquidate the company];

- Indicate if the adjusted cost basis of any of the company's marketable or non-marketable assets reflects a carry-over cost basis, pursuant to a Section 1031 (or similar type) tax-deferred exchange [can provide information on whether the company pursues available tax-deferral strategies];

- Current list of shareholders/partners showing the name of each shareholder/partner and the class and number of shares owned by each shareholder as of the valuation date [can provide information on relative ownership distribution and total number of shareholders];

- Copies of notes receivable (and/or notes payable) between the company and any shareholders, over the five years leading up to the valuation date [loans to/from shareholders might be relevant to evaluating lack of marketability risk];

- Company articles of incorporation and amendments, by-laws and amendments or partnership agreements and amendments [by-laws might address restrictions or procedures for transfer of shares];

- Copy of all shareholder agreements (such as buy/sell agreements, stock option agreements stock purchase agreements, etc.) that have been in effect during the five years prior to the valuation date [shareholder agreements might address restrictions or procedures for transfer of shares];

- All documents pertaining to any sale of the company, a division or unit of the company, or shares (interests) in the company during the five years prior to the valuation date [recent sales/transfers might be might be relevant to evaluating lack of marketability risk];

- Board of Directors Meeting Minutes, for five years leading up to valuation date [Board meetings might address shareholder requests for sale/transfer of shares];

- Complete financial statements of the company for the five fiscal or calendar years prior to the valuation date, including balance sheets, income statements and cash flow statements [can provide additional information for evaluating lack of marketability risk];

- Complete income tax returns for the five fiscal or calendar years prior to the valuation date, including any audit adjustments [tax returns might include details that are not stated within the regular financial statements];

- Brief history and/or description of the company or the company's business (may already be included in an appraisal report) [can provide additional information for evaluating lack of marketability risk]; and

- Brief statement of duties of subject shareholder's participation in company operations [can provide additional information for evaluating lack of marketability risk].

4. Real Estate.

a. Define the Asset – The Most Common Problem in All Valuations.

i. What Type of Interest Is Held – Fee Simple, Contingency, Leasehold, Undivided Partial Interest? In determining the value of an undivided interest in real estate in *Ludwick v. Commissioner*, T.C. Memo. 2010-104, the Court considered the likelihood of partition, the potential length of the partition process, the costs of partition, the buyer's expected rate of return, and the proportional value of an undivided 50 percent interest in the property. *See also*, *Estate of Ellie Williams v. Commissioner*, T.C. Memo. 1998-59 (44% discount for fractional interest).

ii. What Land Is Included? The appraiser must determine the defined boundaries of the land, and the acreage to be valued. Check the title and deed to insure compliance.

iii. What Are the Physical Attributes of the Land? The following characteristics should be considered:

(1) ***Topography (flood plain, soil) –*** If the topography changes throughout the property, this can affect value. For instance, one portion of a large tract of property may be more suitable for development.

(2) ***Natural Resources (minerals, timber).***

(3) ***Improvements (structures, utilities, paved roads).***

(4) ***Pollution (Air or Noise) and Other Environmental Concerns.***

(5) *Zoning (current, ease, and likelihood of change)*.

In *Hayutin v. Commissioner*, 508 F.2d 462 (10th Cir. 1974), the Court accepted the appraisal report of the expert who made necessary adjustments to value based on, among other things, size, topography, location, whether it had water for residential development, soil condition, and improvements.

iv. Encumbrances or Restrictions? The appraiser should contemplate any existing mortgages, liens, easements, and covenants, in determining value. An appraiser comparing the effects of restrictions on property must compare whether the restrictions change the highest and best use and the terms of the restriction.

v. Existing Lease? The appraiser should consider the terms of any existing leases on the property, such as the duration and market rent.

vi. Current or Anticipated Zoning of the Property? A property's use may be restricted based on its zoning classification, which can affect its value. Where a property may easily be rezoned, a court will consider this factor when determining valuation. *See Butler v. Commissioner*, T.C. Memo. 2012-72.

b. <u>Methodology</u>. It is important for the appraiser to consider all three valuation approaches discussed above (market, income, and cost), but the method most appropriate to the situation should be afforded the most weight. Keep in mind that the variability of the factors in the discounted cash flow method can lead to numerous attacks by your opponent. For example, in a conservation easement valuation, your opponent will likely attack the developer's profit, absorption rate, and the appreciation values. In determining what the most appropriate method is, the appraiser must consider the highest and best use of the subject property.

i. Unaccepted Offers? In *Butler v. Commissioner*, T.C. Memo. 2012-72, the Court found unaccepted offers of sale relevant to the portion of land which the offers covered.

ii. Explain Your Analysis. "We have repeatedly emphasized that it is essential for appraisers to explain their reasoning because without [it] the report is useless." *Friedman v. Commissioner*, T.C. Memo. 2010-45.

c. **"Highest and Best Use" (HBU).** The HBU is defined as the use that is legally permissible, physically possible, financial feasible, and produces maximum profits. JAMES R. HITCHNER, FINANCIAL VALUATION APPLICATION AND MODELS (2nd ed. 2006), p. 350. The highest and best use may well differ from the current use. In that event, the valuation must ignore the current use and gauge the value of what is the actual highest and best use (but sometimes carries the label "hypothetical highest and best use"). The asserted highest and best use, if different from the current use, must be both reasonably probable and close in time. Any HBU which depends on events which are outside the realm of possibility will be ignored. *Esgar v. Commissioner*, T.C. Memo. 2012-35. The factors discussed above that define the asset must be analyzed to determine the HBU. The fair market value of property reflects the highest and best use of the property on the relevant valuation date. *Stanley Works v. Commissioner*, 87 T.C. 389, 400 (1986). The appraiser should consider any realistically available special use of property due to its adaptability to a particular business. *Mitchell v. United States*, 267 U.S. 341, 344-345 (1925); *Stanley Works v. Commissioner, supra*. The fair market value of property is not affected by whether the owner actually has put the property to its highest and best use. The realistic, objective potential uses for property control the valuation thereof. *Stanley Works v. Commissioner, supra*. Any restrictions, covenants, *etc.*, must also be considered when determining the highest and best use. Finally, environmental issues must be analyzed in determining the HBU.

d. **"That's No Comparable: That's a Forced or Distressed Sale".** Regulations, Revenue Rulings, Tax Court precedent and State Court precedent reject the use of forced sales in determining fair market value. *See* Treas. Reg. § 20.2031-1(b); Treas. Reg. § 25.2512–1; Rev. Proc. 79-24, 1979-1 CB 565; *Cornelius v. Commissioner*, 56 T.C. 976, 980 (1972); *Estate of Trompeter v. Commissioner*, T.C. Memo. 2004-27; *Perdue v. Commissioner*, T.C. Memo. 1991-478; *Duke Power Co. v. Smith*, 54 N.C. App. 214, 217 (1981); *Carver v. Lykes*, 262 N.C. 345, 137 S.E.2d 139 (1964); and *North Carolina State Highway Commission v. Pearce*, 261 N.C. 760, 762 (1964).

5. **Any Income Stream.** Section 7520 authorizes tables to value "any annuity, any interest for life or a term of years, or any remainder or reversionary interest."

a. **Stunningly Low Discount Rate.** Section 7520 specifies a discount rate of 120 percent of the artificially suppressed Section 1274(d)(1) Federal midterm rate – currently a stunningly low rate.

b. **Life Expectancy Tables.** In the instance of life estates like an annuity, the tables are based on the life expectancies set forth in the Treas. Reg. § 20.2031-7 tables.

c. **Hokey-Pokey Choices.** Depending upon your case, you will want to fight your way into or out of these.

i. **Fighting Your Way Into the Tables.** In the context of a sale by a sick client in exchange for an annuity, you will want to fight your way into the tables to bolster the value of the annuity to match the value of the asset sold. The IRS will try to depress the value of the annuity by excluding your client from the tables as someone with a life exclusion of less than one year under Treas. Reg. § 1.7520-3(b)(4), Ex. 2. The distorted value worked by the tables also drives choices between charitable lead trusts and charitable remainder trusts.

ii. **Fighting Your Way Out of the Tables.** If you died owning an income stream that will survive you, the artificially suppressed current discount rate in the Section 7520 tables will grossly overstate the value – a happy result for estates under the $5 million unified credit which are seeking a bump in basis, but an unbearable result for taxable estates.

(1) ***Three Avenues of Escape.*** Case law, Treas. Reg. § 20.7520-3(b)(1) and its examples provide three avenues of escaping from the dreaded Treas. Reg. § 20.2031-7(d) tables. Those tables do not apply to –

- "A restricted beneficial interest;" or
- Where the table produces "an unrealistic and unreasonable result; or
- The future payments are in doubt.

See O'Reilly v. Commissioner, 973 F.2d 1403, 1408 (8th Cir. 1992); *Maryland Nat'l Bank v. United States*, 609 F.2d 1078, 1081 (4th Cir. 1979); *Weller v. Commissioner*, 38 T.C. 790, 803 (1962).

(2) ***Restrict Beneficial Interest.*** Note that "a restricted beneficial interest" means "subject to any contingency, power, or other restriction, whether the restriction is provided for by the governing instrument or is caused by other circumstances."

(3) ***Unrealistic and Unreasonable Result.*** The "unrealistic and unreasonable result" must be extreme when compared to the fair market value determination.

(4) ***Future Payments.*** The doubt as to future payment must be substantial.

If any one of these exceptions apply, however, "the actual fair market value is based on ALL THE FACTS AND CIRCUMSTANCES" to the extent permitted by the Internal Revenue Code (*i.e.*, Section 2703(b)).

E. Valuation Premise: Do Not Infer Liquidation.

1. Valuation Premise. There are two underlying premises that drive valuations: going concern and liquidation. As their names allude to, the question that must be answered is whether the underlying entity is likely to liquidate at any point in the near future? This inquiry requires consideration of the facts and circumstances, including any indicators that liquidation is part of the plan.

2. IRS Result-Driven Approach. Recently, the IRS has taken a valuation approach that focuses on the operating assets of the on-going business, assuming that taxpayers will cause long-standing successful businesses to liquidate. This asset-liquidation approach to valuation flies in the face of the IRS' own rulings, the standards that govern professional appraisals, and case law.

a. Rev. Rul. 59-60, 1959-1 C.B. 237. In the field of valuation, Rev. Rul. 59-60, 1959-1 C.B. 237 is king. According to Rev. Rul. 59-60, "a sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance." *Id.* at § 3.01.

The appropriate method of valuation depends on whether the entity being valued is an operating entity (going concern) or an investment entity (holding company). Section 5(a) provides:

> In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.

b. **<u>Uniform Standards of Professional Appraisal Practice ("USPAP") and Minority Interests</u>.**

i. The size of the interest gifted plays a significant role in determining the likelihood of liquidation and the propriety of the asset-liquidation method. The essential question is whether the interest gifted has the power to force liquidation?

ii. USPAP Stds. Rule 9-3 provides:

> In developing an appraisal of any equity interest in a business enterprise with the ability to cause liquidation, an appraiser must investigate the possibility that the business enterprise may have a higher value by liquidation of all or part of the enterprise than by continued operation as is. If liquidation of all or part of the enterprise is the indicated premise of value, an appraisal of any real property or personal property to be liquidated may be appropriate.

iii. The comment to USPA Stds. Rule 9-3 goes on to state:

> This Standards Rule requires the appraiser to recognize that continued operation of a business is not always the best premise of value because liquidation of all or part of the enterprise may result in a higher value. However, this typically applies only when the business equity being appraised is in a position to cause liquidation.

iv. The premise which underlines USPAP Stds. Rule 9-3 is fundamental to the valuation inquiry: if the interest being valued is literally incapable of causing the entity to liquidate, and there are no indications that the majority interests are planning to liquidate, you cannot value the minority interest using the asset-liquidation value premise. The minority interest is subject to the will of the majority interest(s).

3. **Asset-Liquidation Has a Limited Role in Valuation.** Even outside of the minority interest context, the asset-liquidation method is often inappropriate in light of the facts and circumstances. Rev. Rul. 59-60 calls for reasoned judgment and common sense, and fair market valuation has always been a fact intensive inquiry. The facts of each case will dictate when liquidation is appropriate. Reasoned judgment and common sense dictate that it is inappropriate to infer liquidation where the facts do not indicate that liquidation is a reasonable prospect

Most investors purchase a business interest with an eye toward the future, and absent overt indicators that liquidation is in the plans, the courts should not even consider the asset-liquidation method. *See Estate of Snyder v. United States*, 285 F.2d 857, 861-62 (4th Cir. 1961) ("If a corporation is about to go into liquidation, the entire answer may be found in liquidating values, data which the parties here have properly ignored, for there is no reasonable prospect that the Charlotte company will be liquidated.").

4. **Caution:** Despite the clear delineation between operating and investment entities, some courts have chosen to adopt an allocation method, that requires party experts to battle each other in an effort to determine the appropriate weight to assign to each method. *See Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002). Remember that at the end of the day, the valuation is based on the willing-buyer/willing-seller standard, and in most cases a willing buyer would not pay for the asset-value of a company he or she had no willingness or ability to liquidate.

III. <u>BEST PRACTICES</u>. It can be difficult to run a successful business and even more difficult to run a family. But mixing the two can have catastrophic consequences to both if not done right. Intra-family dynamics and informal treatment of the family business can undermine the best laid plans. That is why it remains important for family businesses to set out clear policies and procedures for addressing both the business operations and familial obligations of the family business or family office. Below are some key areas and best practices you should address with your anchor clients.

A. <u>Maintain Business Formalities</u>. An overriding theme of these best practices will be to maintain the formalities – procedures, policies, strategies, *etc.* – of any normal business operation. Most family businesses find themselves in trouble due to a lack of formal distinction between the business and the family. Maintaining separate bank accounts, keeping diligent notes and records on business activities, and generally treating the business entity as separate from the family can solve a lot of the legal and familial issues that family businesses commonly encounter.

B. <u>Develop Clear Governance Policies</u>. For most family businesses (like any business), success or failure can stem from issues affecting the overall management of operations. In the family context, a lack of clearly delineated roles, powers, and duties can create chaos in an already chaotic environment. Every family business should develop overarching policies in the following areas.

1. <u>Determine a Decision-Making Hierarchy</u> – A clear hierarchy of decision-making authority, whether that be solely in the hands of the family matriarch or through a multi-generational board of directors, can focus the objectives and goals of the family business without being bogged-down in an intra-family power struggle. Every family business must ask itself how it plans to make decisions.

a. <u>Makeup of Board</u>. One of the more important governance questions in a family business environment after deciding whether a board of directors is necessary, is who should serve on that board? Should family members be allowed to serve? What about non-family members? Do you want a formal board of independent, qualified advisors, or an informal board made of family elders? How many board seats does the business need? Who should chair the board? Typically, the board of directors holds a lot of power over the operations of a business. Who do you trust with that power?

b. <u>Criteria for Board Members</u>. It is important to setup intelligent criteria for selection of board members – not every family member needs to sit on the board (nor should they). These decisions will need to coalesce with strategic aims – who best can help you reach your goals? Families should also ask themselves whether continued control by the family is important. If so, should the business develop a training system to prepare future generations to sit on the board of directors.

c. **Family Governing Body; Family Meetings.** As an alternative to or in conjunction with the board of directors, developing a family council can bifurcate the business and familial responsibility and interests of the family business. Family councils can focus on long-term strategic planning for the family while allowing corporate executives and board members the freedom to focus on running the business. This can be especially useful with large, vocal families who want someone of authority to speak to – whether it be a hair-brained investment strategy or to lodge a complaint about the direction of the company – the family council can serve as a buffer, filtering out inane discussions while facilitating discussions with the business arm of the company.

d. **Interaction Between Board Members and Family.** It is important to set clear boundaries between the business and familial arms of the family business. The use of an experienced, independent board along with the family council discussed above can prove useful in separating the two aspects, but it may not be practical in smaller family businesses. However, even where the board consists largely or exclusively of family members – one should still inquire into how much access non-board family members should have to board meetings. Are non-board members permitted to sit in on meetings? voice their thoughts and displeasures?

2. **Develop Strategic Goals** – Every good business should know what it aims to achieve through its operations. Most family businesses have the same goals of growth and long-term stability as other businesses, but have the added dynamic of providing a source of income for retired generations, college tuition for younger generations, and general support and maintenance for the entire family.

3. **Ownership.** Whether a "Ma and Pa" shop or multi-million dollar family investment company, every family business should draw a line in determining ownership and who can participate in votes or decision making processes.

a. **Participation Qualifications; Succession Planning.** Every family business should consider whether and when older generations should cede power to younger generations and when younger generations may acquire the power to participate. There should be a clear plan in place for facilitating succession of the family business so as not to unnecessarily complicate the power transfer and interfere with business operations.

b. **<u>Shareholder Agreements or Similar Arrangements</u>.** Some family businesses go as far as to enter into shareholder agreements, which delineate various roles and responsibilities of family shareholders. These can be helpful in alleviating the unavoidable jealousy that arises from unequal ownership – and therefore unequal power and income – that often develop with family businesses.

c. **<u>What's In a Family</u>?** Often overlooked but seldom uneventful, the selection of those entitled to participate in the ownership of the family business (and perhaps operations of it) can lead to unforeseen consequences. Ultimately, children grow up and marry, parents' divorce, and older generations can no longer make their own decisions. Every family business should consider who they want to have the right to share in profits, hold an ownership interest, or participate in day-to-day operations. Do spouses get their own interest equal to the family member they marry? What happens if they divorce? What if they have children from a previous marriage?

C. **<u>Develop Sound Operational Policies</u>.** Whether organized as a corporation, family limited partnership or whether organized as an operational entity or investment fund, sound operational policies are essential to any family business – especially when your third-cousin comes looking for a job or "his fair share." Those operational policies can provide clear rules for handling a variety of situations:

1. **<u>Employment Issues</u>.** We all have that (at least) one family member who just cannot help but find themselves on the wrong end of every stick. When you run a family business, there seem to be more of those sorts of family members than you can waive that proverbial stick at. It is important from the outset of any family business to set out clear policies for employment – qualifications, conditions, benefits, expectations of performance, *etc.* – to prevent having to answer questions later about why that third cousin was denied a job or failed to keep the one you gave him.

a. **<u>Qualifications; Performance Reviews</u>.** The development of employment standards and expectations is important in the family business – where familial relationships can cloud judgment. In any employment context, both employers and employees benefit from clearly-defined qualifications and expectations in performance. It is also important that those qualifications and expectations remain uniform across related and unrelated employees. No business wants to lose a qualified employee because related-employees were held to a lesser standard. Clear standards will also help deal with problematic family members who cannot perform the job.

b. **<u>Compensation; Benefits</u>.** Often, a key issue in family business cases remains the level of compensation paid to family employees. More than in any other context, it is important that family employees are paid a reasonable wage – a sometimes fluid concept by itself. Too high of a wage, and the IRS may deem it a gift; too low, and the IRS may treat it as undermining the existence of the business altogether. The family business should clearly document its compensation and benefit decisions. Do you intend to pay a market rate? If so, how do you determine that market rate? What value do you place on various jobs, tasks, *etc.* What perks or benefits do you intend to provide and why?

Compensation can be the single most contentious issue – not just with the IRS – but among family members. Social norms teach us that compensation equates value; that is truer for family members were natural jealousies can be seemingly magnified. There can also be some natural (if not healthy) skepticism of compensation paid to family members involved in the business by those family members not involved. Family businesses should ask themselves serious questions about the transparency of compensation payments and how that compensation will be determined.

c. **<u>Reporting Relationships; Titles</u>.** Another area of business dynamics that can be magnified in the family business context lies with the development of the corporate hierarchy. Titles may be worth very little to the outside world but they can mean everything among family members – especially siblings who have spent their entire life in a healthy spirit of competition. Interpersonal relationships are important to running a business and the hierarchy of power, control, and responsibility should be constantly evaluated to prevent sibling rivalry or deep-seeded family jealousies from ruining the flow of information and production in the family business.

2. **<u>Financial Planning</u>.** Whether the family business is designed to supplement the income of various family members or act as the family piggy-bank, the family business should have a clear set of principles governing the distribution of proceeds, loans, and procedures for redemption of familial interests. It is important to understand what it will take to handle both the short-term and long-term needs of the family.

This includes more than just dividend policies or return of capital. Family businesses must deal with normal business concepts such as adequate capitalization, debt-to-earnings ratio, and operational flexibility. In the context of family businesses operating as family investment companies, these considerations can be made more complex by questions of retirement planning and tracking individual account contributions.

a. **<u>Dividends and Distributions</u>.** Similar to the issue of compensation, the development of clear policies regarding the distribution of profits out of the family business can alleviate a lot of headaches for family business managers. Distribution policies should be based not just on available net profits but on decisions regarding future needs – of the both the business and the family. Smart managers will be sure to communicate that no family member should expect to live off of the distributions from the family business – unless prudent and desirable to develop a policy for taking care of older or infirm family members.

b. **<u>Redemptions</u>.** Thoughtful family businesses will do well to develop exit strategies for family members – whether from employment or from actual ownership. Perhaps more importantly, the family members should be permitted to withdraw from the business without necessarily withdrawing from the family. At the same time, the family business should protect its own interests and develop a mechanism for facilitating withdrawals without jeopardizing the viability of the family business.

c. **<u>Estate Planning</u>.** An important part of financial planning requires thinking about the things no one wants to think about – what happens if I die? In the family business context, it is important to plan for such eventualities, not just from a financial perspective, but from a continuity of ownership and operations perspective. Developing a clear plan for a smooth transition of ownership percentages and replacement on any board or family council seats – or executive positions – will help curb familial infighting over the estate and limit the impact of a devastating loss on business operations.

d. **<u>Non-Employed Owners</u>.** One of the key aspects of financial planning remains what to do with non-employed family owners. How much of a say do these non-employed owners have in the financial planning of a family business? Do they vote on distributions? help write dividend policies? what kind of review powers do they have over such decisions and over compensation determinations made with respect to employed owners?

3. **<u>Selection of Advisors</u>.** Too often, this is a matter of whether and not a matter of how or who? Current and future managers should have clear guidelines in place for selecting professional advisors – whether an estate planning or corporate lawyer, CPA or other tax advisor, or investment advisor – to help guide the company. It should go without saying that every family business would benefit from independent, non-familial advisors to maintain business formalities and provide cover to decision-makers against allegations of conflict of interest and general complaints about business operations.

4. **Interpersonal Relationships.** Inter-office dynamics can be put to the test by the varying personalities of our society – they are certainly put to the test in a family business. As such, it is important for family businesses to develop effective ways to manage the family dynamics of related employees.

   a. **Dispute Resolutions.** Disputes arise in every business – whether related to compensation, promotion, retention, allegations of harassment and discrimination, and the like. Family disputes can involve the same kind of issues and many, many, many more. Family businesses would do well to develop clear avenues for reporting and resolving disputes to streamline resolutions and limit interference with the business.

   b. **Conflict of Interest and Non-Compete Provisions.** In many family business contexts, the prevalence of family "side businesses" can place added strain on both the business and the family. One key area for family business managers to address is whether and to what extent family members can do business with the business. It is important to set clear standards for ensuring the objectivity of decision-making when it comes to such inherent conflicts of interest – such as requiring independent approval and the observance of market standards. On the flip side, when family members decide to branch out on their own, family businesses would be best served to make sure that proprietary information or access to clientele does not leave with them. Non-competes can protect both the family and the business from *intra*-family competition over markets and prevent family in-fighting in the process.

   c. **Communication Guidelines.** One of the largest problems in any business is the lack of communication. A lack of communication can cause and exacerbate problems. Whether its clear expectations of performance, changes to corporate hierarchy, or distribution policies, effective communication plays a key role in managing interpersonal relationships.

   d. **Codes of Conduct.** A code of conduct can establish rules and expectations for how the family interacts within itself and how it interacts with the outside world. Some things should just stay in the family. At the same time, how one family member comports themselves in public can have a lasting effect on the world's perception of the entire family. Would you want to invest in a family investment company where the heir-apparent spends most of their time in an excessive manner?