WRAPPING UP YOUR GIFT TAX RETURN WITH A TIDY BOW – REPORTING GIFTS WITH AN EYE TOWARD AUDIT

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Table of Contents

Page

A. INTRODUCTION 2
1. Generally 2
2. Pre-Transaction Planning 2

B. PREPARING FOR GIFT TAX REPORTING 3
1. Selecting the Return Preparer 3
2. Selecting and Engaging the Appraiser 4
3. Communicating Critical Factual and Legal Information 11
4. Transactions Requiring Additional Consideration 17

C. REVIEWING THE APPRAISAL AND GIFT TAX DISCLOSURE 28
1. Fundamentals of Transfer Tax Valuation 28
2. Definition of Qualified Appraisal 51
3. Critical Elements of the Appraisal 54
4. Understanding Adequate Disclosure Regulations 56

D. PREPARING TO RESPOND TO IRS AUDITS 60
1. Consider Bringing in Litigation Counsel 60
2. Determine Whether a Document Destruction Policy Exists; If So, Suspend 60
3. Implement Your Own "Audit" 61
4. Consider the Burden of Proof 61
5. Consider the Impact of Privileges 61
6. Consider Whether Production of Privileged Information May Help Your Case 62
7. Provide Responses to the IRS that Are True and Correct, to the Best of the Taxpayer's Knowledge 63
8. Keep in Mind that Anything Stated or Written Can Be Treated as an Admission 63
9. Produce Responsive Documents in the Taxpayer's Possession, Custody or Control 63
10. Keep Careful Track of Documents and Electronic Files Produced to the IRS 63
11. Understand the IRS's Broad Summons Power 64
12. File Protective Claims If Necessary 64
13. Consider Whether it is Feasible to Keep Partnership in Place 64
14. In the Estate Context, Beware of Distributing Entity Interests 64
15. Treat Informal Interviews as Depositions 65
16. Understanding the IRS's Settlement Guidelines 65

E. CONCLUSION 65

EXHIBIT A A-1

EXHIBIT B B-1

EXHIBIT C C-1

A. INTRODUCTION

1. Generally

In a typical engagement, most estate planning professionals spend the majority of their time focused on evaluating the tax benefits of proposed estate planning and carefully drafting the legal documents to implement various planning techniques. However, we often overlook the critical fact that the success of the plan is really only complete once the tax consequences of the transaction are finally determined for federal tax purposes, whether upon the running of the statute of limitations or otherwise. Getting to a successful final tax result encompasses much more than good tax planning and drafting. It requires meticulous attention to the facts and circumstances that surround the planning, the presentation of the transaction on the federal gift tax return, and, in some circumstances, the successful navigation of a gift tax audit.

2. Pre-Transaction Planning

a. Don't Create Bad Evidence

Attorneys and clients should keep in mind that anything put in writing may ultimately be read by the Internal Revenue Service ("IRS"), a judge or even a jury. There are some infamous examples of certain incriminating statements making their way into trial:

i. "Guess we have to be real straight on who borrowed what etc. so the partnership looks legit."[1]

ii. "[Y]ou have to get the assets into the LLC first so it's the owner of the assets before you start making transfers."[2]

This means that potential evidence includes not only the actual return, transaction documents and appraisal potential evidence, but also emails, letters, memoranda and even time entries. This fact should be communicated to and understood by all parties, including the accountant, the appraiser and everyone working with the attorney (the junior attorneys and paralegals).

The planning stage also should include consideration and documentation of all substantive non-transfer tax reasons that apply to the situation at hand. The best evidence often comes from correspondence prepared in connection with the transactions. Correspondence should avoid boilerplate non-transfer tax reasons.

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[1] *Estate of Jorgensen v. Comm'r*, 97 T.C.M. (CCH) 1328 (2009).
[2] *Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009), *rev'd in part and remanded,* 630 F.3d 1211 (9th Cir. 2011).

b. Is the Client a "Good" Client?

To be successful, the client must understand and be willing to participate in the critical considerations that go into successful transfer tax planning with closely-held entities.

The attorney should evaluate the client's level of business sophistication, the client's willingness to comply with the governing documents, and the client's willingness to pay professionals to make sure that the transaction is appropriately structured, implemented, reported and administered. Any failure in structure, implementation, reporting or administration could render the planning unsuccessful.

B. PREPARING FOR GIFT TAX REPORTING

1. Selecting the Return Preparer

a. Attorney versus Accountant

At the outset, a determination needs to be made as to whether the attorney or the accountant will prepare the gift tax return. The advising attorney should make sure that the client's accountant has sufficient background in preparing gift tax returns that report the transaction being considered. Regardless of who prepares the return, the return should be viewed as a legal document that is the final piece of the estate planning transaction. Ultimately it should be the attorney's responsibility to review the return to make sure that the transaction is reported properly and all positions are adequately disclosed.

b. Return Preparer Penalties

A tax return preparer is "any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by [the Code]"[3] and includes someone who prepares a substantial portion of a return or claim for refund.[4] The IRS has taken the position that a tax return preparer includes a "person who for compensation prepares all or a substantial portion of a tax return listed in … subsection [3.02 of Rev. Proc. 2009-11], or a claim for refund with respect to any such tax return."[5]

Sections 6694(a) and (b) impose penalties on tax return preparers for conduct giving rise to certain understatements of liability on a return or claim for refund. The § 6694(a) penalty is the greater of $1,000 or 50% of the income derived by the tax return preparer for an understatement of a tax liability that is due to an undisclosed position for which the tax return preparer did not have substantial

[3] Unless otherwise noted, all citations are to the Internal Revenue Code of 1986, as amended (the "Code") and the Treasury Regulations promulgated thereunder.
[4] I.R.C. § 7701(a)(36)(A).
[5] Rev. Proc. 2009-11 § 3.02, 2009-1 C.B. 313 (Jan. 21, 2009).

authority or a disclosed position for which there is no reasonable basis. The § 6694(b) penalty is the greater of $5,000 or 50% of the income derived by the tax return preparer for an understatement of a tax liability that is due to a willful attempt to understate the tax liability or reckless or intentional disregard of rules or regulations.

2. Selecting and Engaging the Appraiser

   a. Evaluating the Appraiser's Qualifications

   The attorney should work with the client to select an appraiser who will provide an independent and qualified appraisal of the fair market value of the transferred interest. In that regard, consider whether the selected appraiser is independent from the client, is credible, is experienced in the area of valuing the type of entity in question, and has the appropriate credentials for federal tax valuation purposes. Perhaps most importantly, the appraiser should not act as an advocate for the taxpayer. The appraiser must be an "independent, qualified appraiser."

   Industry experts do not always make the best impressions on the stand: "There is a growing judicial recognition of the profession of business valuation experts, and a concurrent recognition that expertise in an industry does not necessarily translate into expertise in valuation. A good example of this judicial reaction was articulated by Hon. David Laro in a U.S. Tax Court case: 'The fact that Weinberg is knowledgeable about this industry does not compel us to credit the testimony on the Transferred Assets' fair market value . . . . We do not find that he has expertise in valuing assets for federal income tax purposes. The thrust of Weinberg's expertise centers on marketing, economics, and the like, rather than on the ascertainment of fair market value.'"[6]

   The appraiser should be abreast of all relevant, specific authoritative guidance on performing valuations in a federal income, estate and gift tax environment, including pertinent revenue rulings and case law.

   Some important questions to ask include:

      i. Does the appraiser have audit and litigation experience?

         1. Determine how many appraisals the appraiser has performed for federal tax purposes.

         2. Determine how many of these appraisals have been accepted as filed, examined, and settled, as well as the specifics related to these appraisals.

         3. Determine the number of litigation matters in which the appraiser has appeared and with what results.

[6] Pratt, Shannon P., "Judicial Reactions to Valuation Testimony," *Valuation Strategies*, September/October 1997, at 21.

4. Ask the appraiser for professional references as a method to corroborate the appraiser's assertions regarding qualifications.

5. Ascertain whether the appraiser has ever been retained by the IRS or served as a result of a court appointment.

ii. How are the appraiser's communication skills?

1. Determine whether the appraiser is able to articulate his or her analysis and conclusions in a cogent manner, both verbally and in writing.

2. Ask for copies of redacted appraisals to assess the ability of the appraiser to produce a report.

3. Ensure that the appraisal not only communicates the analysis and conclusions, but delivers these topics in a manner that is targeted to the likely readers of the appraisal, *i.e.*, an IRS estate and gift tax examining attorney, appellate conferee, a federal judge, or even a jury, depending on venue chosen by the taxpayer if the issue is litigated.

4. Although appraisals are inherently focused on financial matters, it is important to remember that the readers of the appraisal may not have a financial background. Therefore, it is imperative that the appraisal be free of financial jargon, acronyms and other financial slang, as these issues impede the comprehension and effectiveness of the appraisal.

iii. Will the appraiser provide an objective and conflict-free opinion of value?

1. Extreme positions can jeopardize your case and your expert's long-term credibility.

2. The appraiser should be an advocate for his or her opinion, not an advocate for a particular result. The trier of fact will generally recognize an appraiser who becomes an advocate and will render a decision accordingly.

3. It is critical that the appraiser be free from conflicts of interest. Exercise caution if the firm providing the appraiser has another relationship with the client, such as providing significant accounting services.

iv. Is the appraiser open to constructive criticism?

1. Do not hesitate to ask the appraiser explain the support underlying his or her opinion.

2. Curtail relationships with appraisers who are defensive or do not adequately explain their opinions.

3. A professional appraiser with experience in a federal tax environment will welcome constructive critiques as an opportunity to bolster the opinion rendered well in advance of any potential trial.

v. Legal Standards for Evaluating Appraisers

Generally, a qualified appraiser is one who "holds himself or herself out to the public as an appraiser."[7] As further provided by the 2006 Pension Protection Act, a qualified appraiser is "an individual who has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary; regularly performs appraisal for which the individual receives compensation; and meets such other requirements as may be prescribed by the Secretary in regulations or other guidance."[8]

In addition, several courts have set precedent as to the standards to be applied in determining whether an appraiser is qualified and what weight to apply to the appraiser's opinion.

1. The Courts evaluate opinion evidence in the light of the "qualifications of the expert and all other evidence of value."[9]

2. "[P]etitioner did not provide respondent with information regarding the identity, qualifications, and credentials of the individual who prepared the Touche appraisal. . . . Further, petitioner did not attach a resume of Mr. Stone to the Stone report so that respondent could evaluate Mr. Stone's credentials."[10]

3. "[W]e give little weight to [son's] appraisal because, as the son of the decedent, he has a personal interest in having the . . . property valued at a low amount."[11]

4. "In the expert report submitted by respondent, Mr. Shelton represents that he has certain qualifications and credentials to perform business valuations that he does not in fact have, including courses on valuation that he has not successfully completed. Mr. Shelton's report also suggests that he is a member of the

[7] Treas. Reg. § 1.170A-13(c)(5)(i)(A); *see also* I.R.S. Publication 561; Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.
[8] Pension Protection Act of 2006, Pub. L. No. 108-280, § 1219(c)(1)(E)(ii), 119 Stat. 1937.
[9] *Parker v. Comm'r*, 86 T.C. 547, 561 (1986).
[10] *Estate of Levy v. Comm'r*, 63 T.C.M. (CCH) 1739, 1740 (1992).
[11] *Estate of Dougherty v. Comm'r*, 59 T.C.M. (CCH) 772, 778 (1990).

American Society of Appraisers, to which he has never belonged. Since Mr. Shelton has not demonstrated that he is qualified to perform a business valuation, we will evaluate his opinion accordingly."[12]

5. "We conclude that Conklin was acting as an advocate and that his testimony was not objective."[13]

b. Terms of Engagement

In most instances, legal counsel will retain the appraiser for reasons further discussed below. The engagement letter should be viewed as a communication tool designed to confirm all of the major issues related to the appraisal assignment. The appraiser's engagement letter should address the following items:

i. The party who is retaining the appraiser;

ii. The financial arrangements, including cost, timing of payment and, if the attorney is engaging the appraiser, that the client is responsible for payment;

iii. The standard of value (for estate and gift valuations the standard of value is fair market value as defined by Treas. Reg. §§ 20.2031-1(b) and 25.2512-1 respectively);

iv. The nature of the interest to be valued and whether the interest is a majority or minority interest;

v. The date of value (For federal transfer tax purposes, the date of value should be contemporaneous to the date of the actual transfer.);[14]

vi. The proposed valuation methodology or approach;

vii. The type of report that is required, *e.g.*, an oral report, letter report, summary report or fully documented report (in most situations for appraisals prepared for federal estate and gift tax purposes the report will consist of a fully documented report);

viii. The information that is needed to commence work on the assignment; and

ix. The general assumptions and limiting conditions associated with the appraisal assignment.

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[12] *Furman v. Comm'r*, 75 T.C.M. (CCH) 2206, 2213 (1998).
[13] *Knight v. Comm'r*, 115 T.C. 506, 519 (2000).
[14] *See, e.g., Estate of Kaufman v. Comm'r*, T.C Memo 1999-119; *Estate of Magnin v. Comm'r*, T.C. Memo 2001-31; *BTR Dunlop Holdings, Inc. v. Comm'r*, T.C. Memo 1999-377; *Estate of Titus v. Comm'r*, T.C. Memo 1989-466.

c. Attorney-Client Privilege and Work Product Doctrine

By engaging the appraiser directly, the attorney may be able to take the position that discussions among the attorney, appraiser and client are protected by the attorney-client privilege and that the appraisal itself is attorney work product unless the appraisal becomes the basis for, and is attached to, the estate or gift tax return.

i. Attorney-Client Privilege

As a general rule, the attorney-client privilege covers client communications made to the attorney with the purpose of seeking legal advice.[15] The attorney-client privilege is the client's to waive, not the attorney's.

The attorney (not the taxpayer) should consider engaging the appraiser to ensure that any work provided by the appraiser to assist the attorney in rendering legal advice should remain confidential. This engagement is often referred to as a "*Kovel* Agreement," named after a landmark case on this issue.[16] Communications made to an appraiser who is assisting an attorney in providing legal services to a client are protected by the attorney-client privilege. (*Note*: if the appraiser's report will be attached to an estate or gift tax return, the Service is likely to take the position, with good reason, that all communications with the appraiser are no longer protected by the attorney-client privilege.)

To meet the *Kovel* elements, the attorney should ensure that the appraiser is assisting the attorney in providing legal services; a written engagement letter in this regard can serve as helpful evidence to preserve the privilege. Such an engagement letter should include terms that focus on the following factors:

1. Control: that the appraiser is engaged by the attorney and working under the attorney's direction.

2. Clarification that appraiser's work is not pure return preparation: that the work is for the purpose of rendering legal advice, not simply for the preparation of tax returns.

3. Ownership: that the work of the appraiser belongs to the attorney.

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[15] *See Scott v. Beth Israel Med. Ctr., Inc.*, 847 N.Y.S.2d 436 (N.Y. Sup. 2007) (holding that employer's e-mail monitoring policy caused e-mails sent to attorney from work to lose attorney-client privilege because they were not confidential, and work product privilege does not apply where careless conduct suggests no concern for protecting privilege). *But see Sims v. Lakeside Sch.*, 2007 WL 2745367 (W.D. Wash.) (holding that web-based e-mails and other materials prepared for communicating with counsel on employer-provided laptop were protected by attorney-client privilege).

[16] *See United States v. Kovel*, 296 F.2d 918, 921 (2d Cir. 1961); *see also United States v. Cote*, 456 F.2d 142, 144 (8th Cir. 1972); *United States v. Tweel*, 550 F.2d 297 (5th Cir 1977); *United States v. Adlman*, 68 F. 3d 1495 (2d Cir. 1995); *Cavallaro v. United States*, 284 F.3d 236, 246 (1st Cir. 2002).

4. Purpose: that any communications to the appraiser are made solely for the purpose of enabling the attorney to provide legal advice to the client.

5. Additional authority regarding attorney-client privilege:

   a. *United States v. Richey*, 632 F.3d 559 (9th Cir. 2011).

   b. *Estate of Manship v. United States,* 236 F.R.D. 291, 296 (M.D. La. 2006), *vacated in part*, 237 F.R.D. 141 (M.D. La. 2006).

   c. *Univ. of Pittsburgh v. Townsend,* 2007 U.S. Dist LEXIS 24620 (Mar. 30, 2007).

   d. Fed. R. Evid. 502.

ii. Work Product Doctrine

1. Generally

The work product of an attorney or his staff in anticipation of litigation is protected from disclosure.[17] In fact, the attorney work product doctrine is not a privilege, although some courts (and many practitioners) refer to it as one. Unlike the attorney-client privilege, its purpose does not lie in protecting confidential communications; rather, its purpose is to encourage lawyers to prepare thoroughly for litigation (whether pending or not) through investigation of the good and the bad, without fear of being forced to aid an adversary at the expense of the client. In addition to its focus upon anticipated litigation, this doctrine also differs from the attorney-client privilege in that its protection can be pierced (in very limited circumstances) through no fault of the lawyer or the client.

The doctrine is defined by the narrow scope of its exception in the Federal Rules of Civil Procedure:

> [A] party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and prepared in anticipation of litigation or for trial by or for another party or by or for that party's representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has

[17] *Hickman v. Taylor*, 329 U.S. 495 (1947); Fed. R. Crim. P. 16(b)(2); Fed. R. Civ. P. 26(b)(3).

> substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.[18]

Note that the protection extends beyond just the work prepared by the attorney to work prepared by the client and the client's employees, agents, etc. at the direction of the lawyer.[19]

2. Types of Work Product

   The rule contemplates two types of work product: (i) factual and (ii) opinion or "core" work product. Under unusual circumstances, factual work product is discoverable as described in the above-quoted Rule.[20] By comparison, opinion work product "enjoys a nearly absolute immunity and can be discovered only in very rare and extraordinary circumstances."[21] To qualify for the protection, it is not necessary that the litigation have already been filed or be certain. Statements of the required level of anticipation vary.[22] The fact that the work product relates to a proposed transaction is just one factor that suggests it was not prepared in anticipation of litigation and is not, in and of itself, dispositive.[23]

3. Additional authority regarding work product doctrine:

   a. *United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999).

   b. *United States v. Textron*, 507 F. Supp. 2d 138 (D.R.I. 2007), *aff'd in part, vacated in part, and remanded*, 553 F.3d 87 (1st Cir. 2009).

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[18] Fed. R. Civ. P. 26(b)(3).
[19] *In re Perrigo Co.*, 128 F.3d 430, 437 (6th Cir. 1997).
[20] *See also, e.g., In re Allen*, 106 F.3d 582, 607 (4th Cir. 1997); *Upjohn Co. v. United States*, 449 U.S. 383 (1981).
[21] *Cox v. Adm'r U.S. Steel & Carnegie*, 17 F.3d 1386, 1422 (11th Cir. 1994) (quoting *In re Murphy*, 560 F.2d 326, 366 (8th Cir. 1977)), *modified on reh'g by* 30 F.3d 1347 (11th Cir. 1994).
[22] *See, e.g., Energy Capital Corp. v. United States*, 45 Fed. Cl. 481, 485 (2000) ("Litigation must at least be a real possibility at the time of preparation."); *A. Michael's Piano, Inc. v. Fed. Trade Comm.*, 18 F.3d 138, 146 (2d Cir. 1994) (holding that document must be created "with an eye toward litigation"); *Schiller v. N.L.R.B.*, 964 F.2d 1205, 1208 (D.C. Cir. 1992) (holding that document must be created "in anticipation of foreseeable litigation"); *United States v. Rockwell Int'l*, 897 F.2d 1255, 1266 (3d Cir. 1990) (holding that document must be created "because of the prospect of litigation"); *Binks Mfg. Co. v. Nat'l Presto Indus., Inc.*, 709 F.2d 1109, 1119-20 (7th Cir. 1983) (stating that party asserting privilege must show that "some articulable claim, likely to lead to litigation, [has] arisen").
[23] *United States v. Adlman*, 68 F.3d 1495, 1500-01 (2d Cir. 1995) (finding that corporate officer obtained tax memorandum regarding proposed reorganization from accountant/lawyer at Arthur Andersen).

3. Communicating Critical Factual and Legal Information

   a. Attorney's Role in Communicating Information to Appraiser

      The attorney should define for the appraiser the event that constitutes the transfer. Relevant information includes specifying whether the transfer was a gift or a sale, the identity of the transferor and transferee, and how the legal ownership of the transferred asset was titled before and after the transfer.

      The attorney should also be the final arbiter on the nature of the transferred interest as defined under substantive law. For example, in the case of a transfer of a partnership interest, the attorney should specify whether the transferee receives the interest as a partner or as a mere assignee or whether transferred stock is voting or nonvoting stock. Of course, the appraiser should have a thorough enough understanding of the transaction to probe with relevant questions.

      Fundamentally, the attorney should communicate clearly about particular facts, circumstances and client expectations. Remember that bad legal facts plus a good appraisal produce a bad result; at the same time, good legal facts plus a bad appraisal produce a bad result. Neither results in a happy client.

   b. Communication of Rights and Benefits Associated with Transferred Interest

      Once the interest has been defined, the rights and benefits of the interest must be identified. The rights and benefits related to the interest being valued are defined by the relevant governance documents and statutory guidance. The following are common rights and benefits that should be analyzed thoroughly in identifying the rights and benefits of the interest being valued:

      i. Business purpose of the entity.

      ii. Election and removal of general partner, manager, or managing member.

      iii. Approval rights for major decisions of the entity.

      iv. Return of capital contributions.

      v. Capital call provisions.

      vi. Allocation of income or loss.

      vii. Right to determine distribution policy.

      viii. Right to partition entity property or prohibition of such right.

      ix. Presence or lack of right of first refusal.

      x. Provisions regarding the § 754 election.

xi. Withdrawal rights and restrictions on withdrawal.

xii. Implications regarding the term or remaining term of the entity.

xiii. Provisions for liquidation and withdrawal.

xiv. Consents required for admission of an assignee to partner or member status.

xv. Buy-sell or other restrictive agreements.

xvi. Restrictions on ownership or admission of partners / members.

c. Appraiser's Due Diligence of Fundamental Position of the Entity

In addition to defining the rights and benefits associated with the transferred interest, the appraiser should conduct thorough due diligence into the non-legal factors that will condition the valuation. This involves an analysis of the fundamental position of the business and the markets in which the entity conducts business. The objective of this phase of the appraisal is to investigate and then analyze the primary qualitative factors that influence the business and ultimately influence the value of the entity. In other words, the appraiser should strive to obtain the information necessary to tell the story behind the business and its outlook and thus capture the essence of the entity. In many instances, this information will reside with the company's owners and management, who should be interviewed. The following topics and subsequent questions provide some insight into the fundamental position of the business:

i. History of the Business

1. When and by whom was the entity organized?

2. What are the date and state of incorporation or registration?

3. What were the original operations?

4. What were the major developments in the history of the business?

5. What changes in ownership and control occurred over the years?

ii. Capitalization, Ownership and Management

1. How many classes of equity does the entity have, and what are their features?

2. Who are the owners of the entity?

3. What are the family relationships of the shareholders?

4. What are the plans for succession of the business?

5. Who are the officers, directors and key employees?

6. What are the levels of compensation for the owners and directors?

7. What is the background of the officers, managers and directors?

iii. General Economic and Industry Conditions and Comparisons

1. What are the general economic conditions that affect the entity's prospects for continued business?

2. What are the industry trends that affect investment decisions and demand?

3. What types of comparisons are relevant between the industry trends and the general economic trends?

4. What types of comparisons are relevant between entity revenue trends and industry trends?

5. What are the primary industry associations in the entity's industry?

iv. Regulation

1. What is the current regulatory environment?

2. What is the future regulatory environment?

v. Employees and Management

1. What is the size and makeup of the work force?

2. What type of wage/compensation structure does the business have?

3. Is the wage/compensation structure reflective of the industry and region?

4. Are the employees unionized?

5. What is the rate of employee turnover and attrition? Why?

6. What is the status of employee-management relations?

vi. Marketing

1. What markets does the entity serve?

2. Who are the entity's primary customers?

3. What is the revenue volume related to each of these customers?

4. What is the entity's market share in its market(s)?

vii. Product/Service Lines

1. What products and services are provided?

2. How are selling prices determined?

3. How are the products and services marketed and delivered?

4. Are there seasonal or cyclical aspects to the entity's revenues?

5. Does the entity have any brochures or price lists descriptive of its product and service lines?

viii. Supplier Relationships

1. What are the key raw materials?

2. Who are the key vendors?

3. How are supplier relations?

4. Do alternate sources of supply exist?

ix. Market Position

1. What is the entity's status with respect to other firms?

2. What is the market niche or market strategy that the firm is trying to exploit?

3. What is the entity's market share?

x. Competition

1. What are the principal competitive considerations (price, quality, service, reputation)?

2. What are the entity's competitive advantages and disadvantages?

3. Who are the important competitors and what are their market shares?

xi. Plant and Equipment

1. What type of physical facilities does the entity occupy?
2. What are the location, condition and adequacy of the facilities?
3. What are condition, age, and adequacy of the equipment?
4. Are there any major pending capital expenditures?

xii. Company Mission, Strategic Plan

1. Has the entity committed its strategic plan to writing?
2. Is the strategic plan tied to a budgetary control process?
3. How do historical results compare with previous budgets?

xiii. Past, Current, or Contemplated Transactions of Interests in Entity

1. Have there been any prior transactions in interests in the entity?
2. If so, what are the details surrounding these transactions?
3. Are there any current or contemplated transactions for the entity?
4. If there are current or contemplated transactions of interests related to the entity, do these transactions involve an initial public offering or sale of a control block?

d. Appraiser's Due Diligence of Financial Statements

Financial analysis involves the quantitative analysis of the entity's income statement, statement of cash flows, and balance sheet. The objective of financial statement analysis should be to tie the qualitative analysis, gained through due diligence and analysis of the fundamental position of the entity, to the financial statement or quantitative analysis. A well prepared valuation is able to make the correlation of the qualitative aspects of the entity to the quantitative aspects of the entity in that the financial statements of the company present the essence of the entity, albeit in numerical form. The following procedures may be considered by the analyst in order to gain an understanding of the financial aspects of the entity.

i. Balance Sheet

1. The balance sheet should be examined for the last five or six years. This is very often accomplished through the use of common size financial statements whereby the appraiser presents the balance sheet accounts as a percentage of total assets. The use of common

size analysis enables the appraiser to identify trends and variations in specific balance accounts and may prompt further inquiries.

2. The balance sheet should be examined for any excess assets and non-operating assets or liabilities (*e.g.*, cash in excess of what is necessary to operate the business, real estate not used in operations, contingent claims, and contingent liabilities).

ii. Income Statement

1. Common size analysis is also useful in analyzing the income statements of the entity, and this is often done by reviewing income statements for a five or six year period. Common size analysis of the income statement facilitates the identification of trends in the income statement and variations in revenue, expense, and profit margins.

2. Inquiries should be made as to any material nonrecurring or non-operating charges or credits that may have occurred over the past several years. Examples of nonrecurring items are losses from natural disasters, losses on discontinued operations, gains on the disposal of an asset, and payments or income associated with lawsuits. Examples of non-operating items include interest and investment income on non-operating assets.

3. Adjustments are sometimes made to adjust accelerated depreciation to a straight line basis, which is more reflective of the economic impact to the entity and consistent with the policies of public guideline companies.

4. The analyst should analyze a ten- to twenty-year trend of revenue and income in order to identify business cycles associated with operations.

5. Historical and prospective dividend payouts should be analyzed.

6. The analyst should obtain copies of prior budgets if available and compare the forecast results with the actual results so that inferences about the current and future forecast of operations may be made. The strategic plan of the entity may also be very useful information and provide significant insight to the entity’s future.

7. The analyst should discuss in some detail the outlook of the entity with management, with particular emphasis on identifying the entity’s opportunities and obstacles.

iii. Financial Ratio Analysis

1. The purpose of financial ratio analysis is to compare the business being valued against its industry peer group. As an over-simplification, the financial ratio analysis considers how the business compares to its peer group.

2. Financial ratios typically are grouped into one of the following categories: (a) liquidity ratios, (b) activity ratios, (c) profitability ratios, and (d) leverage/coverage ratios. Liquidity ratios provide indicators of the entity's ability to meet its obligations. Activity ratios provide measures as to how well an entity utilizes its assets. Profitability ratios provide measures of the entity's operating performance. Leverage ratios measure the use of debt to finance entity operations as well as provide indicators of the long-term solvency of the business. Coverage ratios are related to leverage ratios in that they measure an entity's ability to pay its debt obligations.

4. Transactions Requiring Additional Consideration

a. Consider Whether Tiered Discounts Might Be Appropriate

Depending on the nature of the asset transferred, two layers of discounts might be merited.[24] If the transferred asset is a minority interest in an entity that holds a minority interest in another entity, two sets of discounts could apply to each of the two separate entities.[25] However, where the transferred asset constitutes a significant portion of the parent entity's assets or where the transferred asset is the parent entity's "principal operating subsidiary," the Service may argue that only one level of discounts should be applied.[26]

b. Consider Whether to Aggregate Interests

If the transferred partnership interests include more than one class (*i.e.*, general partnership interests *and* limited partnership interests), be sure to clarify with the appraiser as to whether those interests should be aggregated for valuation purposes (though this is ordinarily an estate tax, not a gift tax concern). For instance, if a general partnership interest and a limited partnership interest are transferred by the decedent, certain authority suggests that the interests should be aggregated. If, however, the general partnership interest was held by the decedent, and the limited partnership interest is held in a marital trust created by

[24] *See, e.g.*, *Astleford v. Comm'r*, 95 T.C.M. (CCH) 1497, 1502 n.5 (2008).
[25] *Id.* (*citing Estate of Piper v. Comm'r*, 72 T.C. 1062, 1085 (1979); *Janda v. Comm'r*, 81 T.C.M. (CCH) 1100 (2001); *Gow v. Comm'r*, 79 T.C.M. (CCH) 1680, 1690-91 (2000), *aff'd*, 19 Fed. Appx. 90 (4th Cir. 2001); *Gallun v. Comm'r*, 33 T.C.M. (CCH) 1316, 1320-21 (1974)).
[26] *Id.* (citing *Estate of O'Connell v. Comm'r*, 37 T.C.M. (CCH) 822, 825, 833 (1978), *aff'd on point and rev'd on other grounds*, 640 F.2d 249 (9th Cir. 1981)).

the decedent's pre-deceasing spouse, the taxpayer should be able to take the position that the interests should *not* be aggregated.[27]

c. Application of Special Valuation Rules

Chapter 14 of the Code includes special valuation rules designed to disregard certain valuation (*i.e.*, estate freeze) techniques when valuing an interest transferred to family members. Section 2701 applies to transfers of certain interests in partnerships and corporations; § 2702 applies to transfers of interests in trusts; § 2703 applies to certain options, agreements and restrictions on the sale or use of property; and § 2704 applies to the treatment of certain lapsing rights and restrictions. The attorney must be sensitive to these provisions when structuring the transaction, and the appraiser must be sensitive to them in preparing the appraisal.

i. Section 2701

Section 2701 is a gift tax provision that provides special valuation rules to determine the amount of a gift when an individual transfers an equity interest (*i.e.*, the growth interest) in a corporation or partnership to a member of the individual's family. The rules of § 2701 are designed to place a minimal valuation on the "applicable retained interest" (*i.e.*, the retained frozen interest) and increase both the value of the transferred growth interest and the amount of the gift. For § 2701 to apply, the transferor or an "applicable family member" must, immediately after the transfer, hold an "applicable retained interest" as defined in § 2701(b). If § 2701 applies to a transfer, the amount of the transferor's gift, if any, is determined by subtracting the value of any family-held retained frozen interests from the aggregate value of the corporation or partnership.

ii. Section 2702

Section 2702 provides special rules to determine the value of a gift when an individual makes a transfer in trust to (or for the benefit of) a member of the individual's family (*i.e.*, the growth interest) and the individual or an "applicable family member" retains an interest in the trust (*i.e.*, the retained frozen interest). If § 2702 applies to a transfer, the value of the retained interest is determined by subtracting the value of the retained interest from the value of the property transferred to the trust. If the retained interest is not a "qualified interest" (as defined in § 2702(c)), the retained interest is generally valued at zero, and the amount of the gift is the entire value of the property transferred to the trust. Section 2702 does not apply to any transfer that is an incomplete gift, to a personal residence trust, or to those transfers listed in Treas. Reg. § 25.2702-1(c).

[27] *See, e.g., Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981); *Estate of Mellinger v. Comm'r*, 112 T.C. 26 (1999); *Nowell v. Comm'r*, 77 T.C.M. (CCH) 1239 (1999); *Jones v. H.F. Ahmanson & Co.*, 1 Cal.3d 93 (1969).

iii. Section 2703

Section 2703 addresses the use of certain arrangements to freeze the value of property retained by a decedent. Section 2703(a) provides that the fair market value of the property is determined without regard to any option, agreement, or other right to acquire or use property at a price less than the fair market value of the property or to any restriction on the right to sell or use the property. However, § 2703(b) provides an exception to the general rule if the option, agreement, right or restriction meets the following three requirements: (1) it is a bona fide business arrangement; (2) it is not a device to transfer property to members of the decedent's family 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 arms' length transaction. Regulation § 25.2703-1(b)(3) provides that a right or restriction is deemed to satisfy § 2703(b) if more than 50 percent of the value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family and (2) the property owned by non-family members is subject to the right or restriction to the same extent as the property owned by the transferor.

iv. Section 2704

Section 2704 addresses the estate tax and gift tax treatment of certain lapsing rights and restrictions on the value of interests in corporations and partnerships. Section 2704(a) provides that certain lapses of voting or liquidation rights in a corporation or partnership are treated as transfers of those rights by the person holding the rights (a gift if the lapse occurs during the holder's lifetime; includible in the holder's estate if the lapse occurs at the holder's death). Section 2704(b) provides that any applicable restriction (as defined in § 2704(b)(2)) is disregarded in valuing an interest in a corporation or partnership transferred to or for the benefit of a member of the transferor's family.

d. Defined Value Clause Planning

A defined value clause is designed to define by reference to a specific dollar amount or formula the amount being transferred. The transfer is structured such that the transferor does not technically transfer a specific asset, percentage interest or number of shares; rather, the defined value clause defines a dollar amount worth of such asset, interest or shares as the subject of the transfer. That dollar amount is then typically translated into specific property following the initial transaction, preferably without input from the transferor.

Planning with defined value clauses remains a potential area for audit and possible litigation. Accordingly, ensuring that the transaction is reported properly is fundamental to the success of the technique.

i. Summary of Authority

1. *McCord v. Commissioner*[28]

In *McCord*, the donors used a defined value clause to transfer interests in their family partnership. The transfer occurred using an assignment agreement that transferred the donors' entire interest to four irrevocable trusts, their four sons, and two charitable organizations. The assignment agreement transferred to the four trusts an interest in the partnership equal in value to the donors' remaining GST exemptions. The sons received an amount equal to $6.9 million less the amount given to the trusts. The first charity received a $134,000 interest in the partnership, and any excess value was to pass to the second charity.

Following the execution of the assignment agreement, the donees determined the value of the partnership and calculated their respective interests accordingly. The charities then sold their interests to the trusts and the sons. The IRS disregarded the defined value clause and revalued the interests that ultimately passed to the trusts and the sons, resulting in a $2 million gift tax deficiency.

The Fifth Circuit upheld the use of the defined value clause, ruling that the assignment agreement, not the subsequent agreement among the donees, determined the donors' transfer tax consequences. Further, the court criticized the lower Tax Court opinion for having considered post-gift events in applying the gift tax. Of note in *McCord* was that the Commissioner did not raise properly the public policy arguments advanced in *Comm'r v. Procter*,[29] the seminal case in which the Fourth Circuit denied a taxpayer's use of a so-called "savings" clause.

2. *Estate of Christiansen v. Commissioner*

Christiansen involved the use of a defined value clause in a qualified disclaimer. The decedent's child – who was also the executrix of the estate – disclaimed her interest in the estate as to any amount exceeding $6.35 million. Values were to be as finally determined for federal tax purposes. According to the decedent's will, if any amount was disclaimed, 25 percent was directed to a charitable foundation and 75 percent was directed to a charitable lead annuity trust ("CLAT"). (The daughter was also a fiduciary of each.) Based on the values from the estate tax return, about $150,000 was left to be divided between the foundation and the

[28] *McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006).
[29] *Comm'r v. Procter,* 142 F.2d 824 (4th Cir. 1944).

CLAT following the daughter's disclaimer. The value of the estate was comprised predominantly of interests in a family partnership, which was reported at a combined 35 percent discount from net asset value on the return. The IRS revalued the gross estate at around $9.5 million.

a. Tax Court Decision[30]

Notably, the Commissioner did rely on *Procter* and argued that the clause triggered a condition subsequent in violation of public policy. However, the Tax Court opinion disagreed, reasoning:

i. The transfer was complete as of the decedent's date of death. The qualified disclaimer related back to that date.

ii. Because the transfer was complete as of the decedent's date of death, there was simply a need to determine values as of that date.

iii. There was no condition subsequent.

Further, the Tax Court rejected the Commissioner's public policy arguments. Although the court recognized that public policy arguments have some role in applying the tax law, such application is appropriate only where the threat posed is severe and immediate. This threat was not present; to the contrary, the defined value clause actually promoted a more important and clearly expressed public policy—tax deductions for charitable contributions.

b. Eighth Circuit Decision[31]

Although the Eighth Circuit's opinion did not expressly address *Procter*, it strongly rejected the Commissioner's public policy arguments.

In response to the Commissioner's argument that upholding the use of defined value clauses would eliminate the audit incentive, the court admitted that such clauses may "marginally" detract from the IRS's incentive to audit. However, the court provided three reasons for declining to apply the tax law in a manner that maximizes the audit incentive:

[30] *Estate of Christiansen v. Comm'r,* 130 T.C. 1 (2008).
[31] *Comm'r v. Estate of Christiansen,* 586 F.3d 1061 (8th Cir. 2009).

i. The Commissioner's primary job is to supervise and enforce the tax law, not to maximize revenue.

ii. There is no clear congressional intent indicating that the tax law must be interpreted in a manner that maximizes the incentive to audit. To the contrary, congressional intent expressly favors charitable giving.

iii. On the facts in Christiansen, incentives to accurately value the transferred assets existed even in the absence of the Commissioner's audit of a return.

It was point (iii) above that was most damaging to the Commissioner. It was premised on three further points:

i. The court pointed out that competing fiduciary duties among the various donees provided an incentive to ensure proper valuation. This conclusion is interesting, particularly in light of the fact that the decedent's daughter served in multiple fiduciary capacities.

ii. The court emphasized that state and federal law would impose liability on such fiduciaries for any misdealing that could occur.

iii. The court also recognized that the state attorney general and the Commissioner had the power to supervise the charities. Particularly, the Commissioner had the ability to revoke tax-exempt status.

3. *Estate of Petter v. Commissioner*[32]

The *Petter* decision is important because of the fact that it approves of a defined value clause in a gift-sale setting.

In *Petter*, the donor formed a family LLC to hold marketable securities. She transferred the stock to two grantor trusts through a gift-sale transaction. She seeded the trusts with an initial gift, using a single instrument to transfer a specified number of units in the LLC to each trust and to a charitable organization. The instrument purported to transfer to each trust a number of membership units equal in value to one-half of the donor's

[32] *Estate of Petter v. Comm'r*, 98 T.C.M. (CCH) 534 (2009).

remaining gift tax exemption. Each charity was to receive the transferred membership units exceeding this value. Next, she assigned additional membership units to each trust and to charities. The trusts purchased units worth about $4 million, and the charities were entitled to any units exceeding this amount. The charities were represented by outside counsel.

The parties then allocated membership units among themselves based upon the defined values and a formal appraisal. The IRS revalued the units, assessing gift tax against the donor and denying a charitable deduction for the excess value passing to the charities. However, the Tax Court held against the Commissioner. The court based its opinion on the factual findings that the deal was negotiated at arm's length with independent counsel and that the charities were admitted as members, not merely as assignees. More importantly, the court evaluated the application of public policy to tax law. Because no severe or immediate threat necessitated such application, the court declined to invalidate the clause on public policy grounds.

4. *Hendrix v. Commissioner*[33]

In *Hendrix*, the donor used a *McCord*-style defined value clause to transfer approximately $15 million of stock in a closely-held corporation to two trusts for the benefit of children and grandchildren, with any excess passing to the Greater Houston Community Foundation. The terms of the transfer permitted the trusts and the Foundation to determine the fair market value of the stock and divide it accordingly among themselves. Subsequently, the trusts obtained an appraisal valuing the stock, which the Foundation further reviewed through its independent appraiser. Approximately five months after the initial transfer, the trusts and the charitable foundation divided the transferred stock pursuant to a "confirmation agreement" based on the appraisal.

The IRS argued the same public policy grounds as in *Christiansen* and *Petter*, but again to no avail. The Tax Court emphasized that the standard to be applied was one of "severe and immediate frustration of national or state policy." For the same reasons as previously held, the Tax Court found that no such violation of public policy was present in the use of the defined value clause.

Additionally, the Commissioner argued that the clause should be disregarded because it was not reached at arm's length. The Tax Court applied a relatively low standard in determining whether

[33] *Hendrix v. Comm'r*, 101 T.C.M. (CCH) 1642 (2011).

there were arm's length negotiations, and held that indeed there were. The trusts bore real economic and business risks on account of exchanging promissory notes for the stock, and the Foundation demonstrated arm's length negotiation on account of the history of donations, potential loss of tax-exempt status, actual negotiation of terms, retention of independent counsel, review of the appraisal, and its general fiduciary duties.

5. *Wandry v. Commissioner*[34]

Wandry involved a much simpler transaction whereby the donors transferred "a sufficient number of units" in their LLC so that particular donees received a dollar amount worth of units. The gift provided that if, after the number of gifted units was determined based on a valuation, the IRS challenged such valuation and a final determination of a different value was made by the IRS or a court of law, the number of gifted units was to be adjusted to equal the specified dollar amount. The donors had an appraisal completed to determine the number of units each donee received; however, the schedule describing the gifts stated that each donee received a specific percentage interest in the LLC.

In Tax Court, the IRS made three arguments against the transaction, rounding out its third with its long-standing public policy argument against savings clauses.

a. The Commissioner argued that the gift descriptions, as part of the gift tax returns, were admissions that the donors transferred fixed percentage interests to the donees. This argument was based on the principle that statements made in a tax return signed by a taxpayer may be treated as admissions. The Tax Court found that nothing the donors had done exposed them to such an argument. Although the schedules to the donors' gift tax returns listed percentage interests, the gifts were still reported as fixed dollar gifts.

b. The Commissioner argued that the capital accounts controlled the nature of the gifts. The Tax Court found that the facts and circumstances of the gift determine the capital accounts of the donees; the capital accounts do not determine the nature of the gift.

c. The Commissioner argued that the gift documents themselves transferred fixed percentage interests to the donees because the defined value clause was void against

[34] *Wandry v. Comm'r,* 103 T.C.M. (CCH) 1472 (2012), *nonacq.,* 2012 WL 5473819 (IRS ACQ).

public policy. Relying on *Procter*, the IRS argued that the donors' use of the defined value clause was contrary to public policy because (1) any attempt to collect the tax would defeat the gift, thereby discouraging efforts to collect tax, (2) the court would be required to pass judgment upon a moot case, and (3) the clause would reduce the court's judgment to a declaratory judgment. The Tax Court rejected the IRS's public policy arguments by reconfirming the distinction between the type of savings clause used in *Procter* and the type of defined value clause used in *McCord*, *Christiansen, Petter* and *Hendrix*. A savings clause is void because it creates a transfer involving a "condition subsequent" in which the donor tries to "take property back" based on IRS redetermination. On the other hand, a defined value clause is valid because it relies on a "condition precedent" to transfer a "fixed set of rights with uncertain value."

Although the donors prevailed, some practitioners question how much weight should be placed on *Wandry* as a memorandum opinion from the Tax Court. The significance of *Wandry* as precedent is also brought into question by the fact that the Commissioner appealed the decision to the Tenth Circuit and then mysteriously withdrew the appeal. This leaves many wondering whether the Commissioner is waiting to save the fight for another case and jurisdiction.

ii. Planning Techniques and Reporting Recommendations

1. General Reporting Recommendations

Although the donors "got away" with poor reporting in *Wandry*, the proper reporting of the defined value gift should be viewed as critical to its success.

a. All Documentation Should Reference a Defined Value

Because the transfer that occurs when using a defined value is of a dollar amount worth of property, and not of a percentage interest or number of shares, all documentation referencing the transfer should state the transferred interests as dollar amounts. This includes both the filing of the gift tax return and any other documents that reference ownership (including the partnership tax return and operating agreement). This is sometimes an issue in administering the entity, as the facts in *Wandry* highlight. In these cases, stating the transferred interest as a

percentage should be acceptable so long as an appropriate footnote is included stating that the percentage is subject to adjustment until there is final determination for transfer tax purposes.

b. All Documentation Should Reference the Appraisal and the Transaction Documents

In the event that the transferred interests do refer to percentages instead of fixed dollars amounts, the explanation of the percentage should include a reference to the appraisal by which the percentage interest was determined. Further, the documentation should express that the percentage interest is for illustrative purposes only, and the transferred interest is governed by the transaction documents that created the defined value transfer.

2. *McCord / Petter* Planning

a. Generally

A transfer with a defined value to a non-charitable beneficiary with excess value passing to charity, remains the safest way to plan. It involves multiple parties with competing interests and avoids any amount passing back to the donor. *McCord* involved a straight gift, and *Petter* involved a gift and sale. Both plans involved charitable entities negotiating about value. Of course, this technique requires that the donor have some charitable motive. Amounts passing to charity should be more than just nominal. Potential benefits to charity should materially exceed any transaction costs of hiring independent counsel to negotiate the transaction.

b. Reporting

In addition to the general reporting recommendations, *McCord* / *Petter* type planning must disclose the transfer of the interest to charity. The donor's income tax return and gift tax return should disclose the transfer, and should do so consistently. Failure to report the gift to charity may result in a lengthening of the statute of limitations from three years to six years under the substantial undervaluation rules,[35] if the gift to charity is large enough.

[35] I.R.C. § 6501(e)(2).

3. Complete / Incomplete Gift Trust

a. Generally

If the donor does not wish to incorporate a charity in the planning, a defined value clause can allocate excess value to a trust that is structured as a partially complete and partially incomplete gift trust. For example, 10 percent of the excess value can be allocated to a subtrust under the trust that will constitute a completed gift for gift tax purposes. This erodes the IRS's public policy argument that there is no incentive to audit – an important point if charities are not involved. The remaining 90 percent can pass to a subtrust that constitutes an incomplete gift for gift tax purposes. This easily can be achieved by providing the donor with a general power of appointment, which the donor can exercise to engage in further planning.

b. Reporting

In addition to the general reporting recommendations, the transfer to the incomplete gift trust should be reported as an incomplete gift disclosed on the gift tax return.

4. *Wandry* Planning

a. Generally

Because *Wandry* planning does not include a residual donee, reporting the gift may be simpler. From a structuring standpoint, however, it is best to have the donee be a grantor trust. Accordingly, if there is an adjustment of the value, the overall income tax consequences do not shift because the donor will have reported all of the income on his or her income tax return.

b. Reporting

Gift tax reporting should be done in accordance with general reporting recommendations. The donor's income tax return and a grantor trust reporting should be coordinated appropriately.

5. Other Techniques

a. Generally

A variety of other techniques using defined value clauses have recommended using alternative residual donees, such as a grantor retained annuity trust ("GRAT") or an inter vivos qualified terminable interest property ("QTIP") trust.

b. Reporting

Reporting of these techniques should be sensitive to other reporting issues associated with the particular technique. For example, in the case of the GRAT, reporting should be sensitive to the estate tax inclusion period ("ETIP") and the need to elect out of automatic allocation of generation-skipping transfer tax exemption at the expiration of the ETIP, if so intended. In the case of the QTIP trust, the QTIP election must be made.

6. Sample Language

The defined value gift can be disclosed as follows:

> A gift of that percentage assignee interest in HoldCo, LLC, a Delaware limited liability company, with the fair market value equal to $5,000,000, as finally determined for federal transfer tax purposes, represented by the "Transferred Interest" as defined in the attached Assignment dated December 31, 2012. As per the attached appraisal prepared by John Smith of a 1% membership interest in HoldCo, LLC, the percentage of membership interest in HoldCo, LLC reflecting this gift is ___%.

The term "Transferred Interest" would be defined on a formula basis, in the assignment document effectuating the gift.

C. REVIEWING THE APPRAISAL AND GIFT TAX DISCLOSURE

1. Fundamentals of Transfer Tax Valuation

a. Definition of Fair Market Value

i. Generally

Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any

compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[36]

ii. Revenue Ruling 59-60

This Revenue Ruling has been the fundamental guideline for valuing closely held business interests in the federal income, estate and gift tax environments for over 50 years. Revenue Ruling 59-60 has stood the test of time and is regarded as one of the most widely accepted guidelines used by business appraisers and users of business appraisals. The ruling states that its purpose is to "outline and review in general the approach, methods, and factors to be considered in valuing shares of the capital stock of closely held corporations for estate and gift tax purposes." The ruling sets forth the following criteria as relevant for the valuation of closely held business interests:

1. The nature of the business and the history of the enterprise from its inception.

2. The economic outlook in general and the condition and outlook of the specific industry in particular.

3. The book value of the stock and the financial condition of the entity.

4. The earning capacity of the entity.

5. The dividend-paying capacity.

6. Whether or not the enterprise has goodwill or other intangible value.

7. Sales of the stock and the size of the block of stock to be valued.

8. The market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

b. The Willing Buyer and Willing Seller Test

The fair market value test is predicated on the willing buyer and the willing seller as hypothetical market participants. The value they place on property is independent from any values or emotions actual parties might possess.[37] The hypothetical parties have general characteristics, not the characteristics of actual

[36] *See* Treas. Reg. §§ 20.2031-1(b), 25.2512-1.
[37] *See, e.g.*, *Meaker Co. v. Comm'r*, 16 T.C. 1348, 1354-55 (1957); *Whittemore v. Fitzpatrick*, 127 F. Supp. 710, 716 (D. Conn. 1954). *But see Estate of Palmer v. Comm'r*, 839 F.2d 420 (8th Cir. 1988), *rev'g* 86 T.C. 66 (1986).

buyers and sellers;[38] they are strangers with no familial connections. Furthermore, the hypothetical parties are neither pessimists nor optimists.[39] Most importantly, they are rational actors who seek to maximize their own economic advantage.[40] Courts will assume that the hypothetical parties make rational decisions to advance their financial positions to the greatest extent possible; to this end, courts may not assume transactions that are contrary to the hypothetical parties' economic interests.[41]

Fair market value arises from the willingness of the hypothetical buyer and the hypothetical seller to enter into the transaction. The willing exchange contemplates a market bargain where the seller is free to make known the availability of the interest, and the buyer is able to explore the market for the lowest price.[42] Neither is under compulsion, and both are free to buy and sell as they please. Forced liquidation and fire sales negate willingness. The transaction occurs under realistic market conditions in the absence of economic constraints.[43]

Additionally, the hypothetical parties have knowledge of all relevant facts. This means that on the valuation date, they have knowledge of the relevant facts and circumstances existing at that time. The hypothetical parties are not clairvoyant, however, and future events may be considered only if they were reasonably foreseeable on the valuation date.[44] For the hypothetical parties to transact in a willing manner commensurate with market bargaining, they must be equipped with the proper foundation for making informed decisions. Accordingly, they are deemed to have the most reliable and accurate information that a reasonable and intelligent investigation would reveal. This knowledge also arises from a hypothetical vantage point. The hypothetical parties are imputed all relevant knowledge, even if actual parties lack such information.

c. Selection of Appraisal Methodology

i. Income Approach

The income approach is defined by the American Society of Appraisers as "a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more

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[38] *See, e.g.*, *Estate of Curry v. United States*, 706 F.2d 1424, 1428, 1431 (7th Cir. 1983); *Estate of Bright v. Comm'r*, 658 F.2d 999, 1005-06 (5th 1981); *Estate of Davis v. Comm'r*, 110 T.C. 530, 535 (1998); *Estate of Newhouse*, 94 T.C. 193, 218 (1990), *nonacq.* AOD 1991-06.

[39] *Compare Estate of Dunn v. Comm'r*, 79 T.C.M. (CCH) 1337, 1340 (1999) (noting actual shareholders' optimism concerning future returns), *rev'd on other grounds*, 301 F.3d 339 (5th Cir. 2002), *with id.* at 1345 (recognizing that the willing buyer may have incentive to liquidate).

[40] *See, e.g.*, *Estate of Watts v. Comm'r*, 823 F.2d 483, 486 (11th Cir. 1987); *Estate of Curry*, 706 F.2d at 1431; *Propstra v. United States*, 680 F.2d 1248, 1251-52 (9th Cir. 1982); *Estate of Bright*, 658 F.2d at 1005-06; *Estate of Newhouse*, 94 T.C. at 218; *Estate of Borgatello*, 80 T.C.M. (CCH) 260, 264 (2000).

[41] *Estate of Curry*, 706 F.2d at 1428-29.

[42] *Comm'r v. Estate of Stewart*, 153 F.2d 17, 18-19 (3d Cir. 1946); *Helvering v. Warbridge*, 70 F.2d 683, 684 (2d Cir. 1934).

[43] *See, e.g.*, *Estate of Curry*, 706 F.2d at 1431-32; *Estate of Newhouse*, 94 T.C. at 218.

[44] *See Estate of Simplot v. Comm'r*, 112 T.C. 130, 152 (1990), *rev'd on other grounds*, 249 F.3d 1191 (9th Cir. 2001); *Estate of Newhouse*, 94 T.C. at 218; *Estate of Gilford v. Comm'r*, 88 T.C. 38, 52-53 (1987); *Messing v. Comm'r*, 48 T.C. 502, 509 (1967).

methods through which anticipated benefits are converted to value."[45] Thus, the theoretical foundation for the income approach is that the value of the business interest is equal to the present value of future benefits into perpetuity.

The income approach is based on the economic principle of anticipation (sometimes also called the principle of expectation). In this approach, the value of the subject investment (*i.e.*, the subject business interest) is the present value of the economic income expected to be generated by the investment. As the name of this economic principle implies, the investor "anticipates" the economic income "expected" to be earned from the investment. This expectation of prospective economic income is converted to a present worth that is the indicated value of the subject business interest.[46]

The income approach is often used when no reliable market guideline companies are available or as a "check" for a market based result. As with the market approach, the income approach may take the form of several methods. These methods are further divisible into two general categories: capitalized returns methods and discounted future returns methods. Capitalized returns methods include capitalization of earnings, capitalization of net cash flow and capitalization of gross cash flow. Discounted future returns methods include discounted net cash flow and discounted future earnings.

1. Capitalized Returns Method

The capitalized returns method involves the conversion of an estimate of a normalized earnings parameter (*e.g.*, net cash flow) into an indication of value in one step by dividing the earnings estimate by a capitalization rate.

a. Capitalization Rate

The American Society of Appraisers defines capitalization rate as "any divisor (usually expressed as a percentage) used to convert anticipated economic benefits of a single period into value."[47]

b. Discounted Future Returns Method

The discounted future returns method is based on the future benefits (in terms of earnings or cash flow), discounted to a present value at an appropriate (risk-adjusted) discount rate.

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[45] American Society of Appraisers Business Valuation Committee, *Business Valuation Standards* (2009), at 10.
[46] Pratt, Shannon P, *Valuing a Business (5th ed.),* (New York, New York: McGraw Hill, 2008), at 175-76.
[47] *Id.* at 26.

c. Discount Rate

The American Society of Appraisers defines discount rate as "a rate of return used to convert a monetary sum into present value."[48] In the context of the income approach, the capitalization rate is derived by subtracting the estimated long-term growth rate from the discount rate.[49]

d. Advantages of the Capitalized Returns Method

i. It is relatively straightforward, uses simple arithmetic and is easy to understand.

ii. It is particularly relevant when the entity's current earnings or cash flow used can be estimated with a higher degree of confidence in comparison to the future earnings of the entity.

iii. It is a widely accepted method embraced by the business appraisal profession.

e. Disadvantages of the Capitalized Returns Method

i. The estimate of the benefit stream to be capitalized may be considered to be too simplistic for the valuation of relatively complex business entities.

ii. It is challenging to develop and support an appropriate capitalization rate derived from the market. Revenue Ruling 59-60 "admits that determination of the appropriate discount rates for use in determining fair market value based upon earnings or dividends is one of the most difficult tasks involved in the valuation process."[50]

iii. The value conclusion may vary substantially based on moderate changes in the estimate of the benefit stream.

iv. The value conclusion is sensitive to what may be considered as "minor" changes to the capitalization rate, particularly with respect to growth assumptions underlying the makeup of the capitalization rate.

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[48] *Id*.

[49] Pratt, Shannon P. and Laro, David, *Business Valuation and Federal Taxes (2d ed.)* (Hoboken, New Jersey: John Wiley & Sons, Inc., 2011), at 176.

[50] Todd and Hemphill, 831 T.M. *Valuation of Corporate Stock* (1995), at A-12.

f. Advantages of the Discounted Returns Method

i. Unlike the capitalized returns method, the discounted returns methods incorporate the forecast of more than one year's financial results in estimating value. As opposed to the capitalized returns method, this allows the appraiser to allow for variations in future results of the entity.

ii. The method is conceptually sound, as value is related to expectations of future performance and economic benefits.

iii. The discounted returns method is particularly useful when the entity being valued has a long history of preparing budgets and the prior budgets are highly correlated to the actual results in those periods.

g. Disadvantages of the Discounted Returns Method

i. Future earnings or cash flow forecasting comprises eight elements: economic assumptions, sales forecasts, purchase forecasts, payroll forecasts, non-payroll operating expenses forecast, capital expenditures forecast, taxes forecast and financing forecast.[51] This is essentially a capital budgeting, and inherently complex, process.

ii. The method involves a layering of assumptions, and quite possibly, a multiplication of errors.

iii. Some models of this method are very sensitive to the underlying assumptions and can yield wild swings in value conclusions based on changes to these assumptions.

1. "In theory, this approach (the discounted cash-flow method) is fundamentally sound and even widely accepted as most pure and correct. However, it can be a minefield for the analyst if it not carefully developed."[52]

2. "In the hands of sloppy analysts, DCF valuations can be manipulated to generate

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[51] Tuller, Lawrence W., *Small Business Valuation Handbook*, (Holbrook, Massachusetts: Bob Adams, Inc., 1994), at 40.
[52] Fodor and Mazza, "Business Valuation Fundamentals for Planners," *Journal of Financial Planning*, Oct. 1992.

estimates of value that have no relationship to intrinsic value."[53]

3. "Despite the popularity of these approaches (discounted cash flow), you should approach these type of valuations with caution. There is a great potential for distortion because of the estimation and forecasting involved."[54]

iv. Many times, the value of the company at the end of the forecast period (known as the terminal or continuing value) represents the majority of the value of the entity being valued. Due to the construction of many discounted future return models, the terminal value is one of the most volatile aspects of the model. Accordingly, volatility in estimation of the terminal value can cause wide variations in value conclusions.

v. There is some disagreement within the business valuation profession as to whether a control-based value or a minority-based value is derived through the use of a discounted future returns approach. The central issues in these disagreements are the specific procedures employed in formulating the forecasts.

h. Steps in Preparing the Capitalized Returns Method

i. Obtain financial statements for a period of five or six years.

ii. Adjust the financial statements for items of a nonrecurring or unusual nature .

iii. If a cash flow forecast is desired, make additional adjustments to convert earnings to cash flow, such as adding back non-cash charges (commonly depreciation and amortization), anticipated capital expenditures, and changes to working capital.

iv. Prepare an estimate of the appropriate capitalization rate by using one or more of the recognized methods, such as the build-up method or the Capital

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[53] Damodaran, Aswath, *Damodaran on Valuation (2d ed.)* (Hoboken, New Jersey, 2006), at 15.
[54] Commerce Clearing House, Inc., *IRS Valuation Training for Appeals Officers* (CCH 1998), at 7-16.

Asset Pricing Model (CAPM), and make provisions for long-term growth in this rate as necessary.

v. Determine the benefit stream to be capitalized, *e.g.*, the latest year results, an average of prior year results or weighted average of prior year results.

vi. Estimate the value of the business entity by dividing the benefit stream by the capitalization rate.

vii. Add the value of any non-operating assets, if any.

viii. Depending on the type of value for the particular assignment (*i.e.*, marketable minority, control, etc.), adjust the value derived by a marketability discount and/or control premium.

i. Steps in Preparing the Discounted Returns Method

i. Prepare or obtain a financial forecast of future financial results.

ii. Adjust the financial statements for items of a nonrecurring or unusual nature, as explained previously.

iii. If a cash flow forecast is desired, make additional adjustments to convert earnings to cash flow, such as adding back non-cash charges (commonly depreciation and amortization), anticipated capital expenditures and changes in working capital.

iv. Prepare an estimate of the appropriate discount rate by using one or more of the recognized methods such as the build-up method or the CAPM.

v. Estimate the value of the entity at the end of the forecast period (terminal value). This is accomplished commonly by the use of the Gordon Growth model in which an estimate of the terminal value is derived by estimation of terminal year financial results, which are then divided by a terminal year capitalization rate. Discount the terminal year value to a present value by applying the discount rate.

vi. Estimate the value of the forecast period benefit stream by discounting each individual year's benefit

stream to a present value by the use of the discount rate.

vii. Add the value of any non-operating assets, if any.

viii. Depending on the type of value for the particular assignment (*i.e.*, marketable minority, control, etc.), adjust the value derived by a marketability allowance or control premium.

ii. Market Approach

The market approach determines an entity's value by comparing the entity to similar entities with more readily ascertainable values. In essence, valuation is determined by relying on the value of guideline transactions. Comparison with publicly traded entities is preferred, as the value of such entities can be determined from prevailing market prices. However, guideline transactions may also be derived from the private market. Once the guideline sales price is determined, it must be adjusted to reflect differences between the guideline entity and the entity being valued. The market approach can be of limited use, as it is appropriate only where guideline entities are similar enough to the entity being valued. Essentially, if the guideline entity broadly represents an alternative investment opportunity that reflects similar investment risk, then reliable indications of value may be derived and used. Where variations between the guideline entity and the entity being valued are too great to be remedied by adjustment, this method is typically avoided.

1. The market approach is defined by the American Society of Appraisers as "a general way of determining a value indication of a business, business ownership interest, security or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests or securities that have been sold."[55] Under the market approach there are two general methods, the guideline company method, and the merger and acquisition method. In rare instances there may be sufficient arm's-length transactions in the equity securities of the subject entity, providing an opportunity to employ past minority transactions, a third method under the market approach.[56] The merger and acquisition method is generally applicable to the valuation of controlling interests. A major advantage that the market approach has over the income and asset approaches is that the market approach relies upon objective data from the capital markets. These data are then used to derive a value for the subject

[55] Business Valuation Standards (2009), at 12.
[56] *See generally*, Pratt, Shannon P., *The Market Approach to Valuing Businesses*, *(2d ed.)* (Hoboken, New Jersey: 2005), at 46.

entity. The result is that, often, there is less subjectivity in the valuation process. Advantages of the Market Approach

a. There is a great body of financial and other data available on publicly held companies.

b. Market prices represent arm's length transactions by many buyers and sellers.

c. The market prices represent minority interest transactions and, therefore, this approach is particularly appropriate in minority interest valuations.

d. The market approach is easy to explain and understand.

2. Disadvantages of the Market Approach

a. It is often hard to find suitable publicly traded companies that are truly similar to the subject entity, particularly when the subject entity is very small.

b. Proper interpretation of stock market data (both price and financial data) may be difficult.

c. There is some disagreement on how to apply this approach in the valuation of a controlling interest.

3. Guideline Company Method

The guideline company method relies on multiples derived from guideline company data. Appropriate multiples are applied to a benefit stream or other variable for the business interest being valued. The guideline company method is also sometimes referred to as the comparative company method. At this point, an observation about nomenclature is warranted. Companies used to provide valuation guidelines are often called "comparative companies," a term which seems to connote companies "just like" the entity being valued. It is seldom, if ever, possible to identify publicly traded companies "just like" the entity which is to be valued. However, a comprehensive, careful review of possible entities in the same or similar industries can produce entities that will provide the best possible valuation guidelines. As a result, the term "guideline companies" may be a more appropriate term than "comparative companies." If a careful determination and analysis of differences between such guideline companies and the subject entity are made, then an informed and reliable valuation conclusion may be reached. The IRS is a strong proponent of the comparative

(or guideline) method when an active market for an interest in the subject entity does not exist.

The following are the steps necessary to perform the guideline company method.

a. Selection of the Guideline Companies

   Several important steps are necessary to properly select the guideline companies for use in the guideline company approach. First, the appraiser must establish the selection criteria. The criteria for selection vary depending on the facts and circumstances and the unique nature of the company being valued. The entities selected should parallel the investment characteristics of the entity to be valued. Selection criteria might include products or services offered, company size, capital structure, markets, geographic diversification, earnings pattern, supplier risk, nature of the competition and position of the company in its chosen industry. The appraiser should prove the impartiality of this selection process by clearly presenting the selection criteria. The entities selected must publish financial data and should trade in active markets.

b. Selection Process

   The appraiser must then search appropriate industry classifications or on-line market proprietary databases or the SEC's EDGAR search engine. After this search, the analyst commonly prepares a table presenting all of the potential guideline companies indicated by source material. The appraiser should then obtain the annual reports for the guideline companies and include a description of each company used in the analysis in the written report.

c. Financial Statement Adjustments

   Generally speaking, adjustments to the guideline companies should be similar to those made to the financial statements of the subject entity. Adjustments may be made to remove nonrecurring items from income statements, to state the guideline companies on a comparable accounting basis (*e.g.*, adjustments for inventory or depreciation differences), and to remove non-operating assets and the effects of discontinued operations.

d. Comparison of Guidelines with the Subject Entity

The appraiser then compiles the financial data on the guideline companies to facilitate the analytical process. A comparison of financial (balance sheet) ratios such as the current ratio, current asset to total asset ratio, net fixed assets to total asset ratio, and leverage measures should be completed. Operating ratio analysis in the form of turnover, profit margin and return on equity indicators are also helpful. Relative long term revenue and income trends are also analyzed. Finally, an analysis of dividend or distribution payment policies should be performed. This is accomplished by reviewing the payout ratios of the guideline companies and comparing these ratios to the dividend-paying capacity of the subject entity. Generally speaking, closely held entities need to retain a greater percentage of earnings than publicly held companies.

e. Development of Valuation Ratios

The development of valuation ratios is central to the application of the guideline company approach. The first step in this process is to compute the total market values of the guideline companies. Subsequently, ratios that compare the market value of the guideline companies to such factors as net worth, earnings, cash flow and dividends are developed. The market value to net worth ratios denote price as a percentage of book value. Market value to earnings ratios are commonly referred to as price to earnings ratios. Critical in the development of these ratios is the base of earnings to be used, *e.g.*, latest year earnings, average earnings, weighted average earnings. In all cases, consistency should be maintained between the guideline companies and the subject entity. Market value to cash flow ratios and market value to dividend ratios are often determined. Industry-specific ratios should be considered. For example, in newspaper valuations, a price to subscriber ratio may be appropriate; in the health care industry, price to bed ratios are commonly used; and in the valuation of precious metal mining concerns, price to production and price to reserve ratios may be useful value indicators.

f. Consideration of Differences Between the Guideline Companies and the Subject Entity

Consideration of differences between the guideline companies and the entity to be valued involves quantitative and qualitative differences. Qualitative differences might relate to differences in size, management depth, geographic, customer and supplier diversification. Quantitative differences include items such as inferior or superior income and revenue trends, inferior or superior margins and rates of return, and inferior or superior financial (balance sheet) condition.

g. Adjust the Valuation Ratios to Take the Differences into Account

The appraiser then adjusts the valuation ratios to take into account the aforementioned qualitative and quantitative differences. Judgment calls should be based on any available market evidence. The relative strengths and weaknesses of the subject entity versus the guideline companies should be reflected in these adjustments.

h. Apply the Adjusted Valuation Ratios to the Subject Entity

The final step in the application of the guideline company method is applying the adjusted valuation ratios to the subject entity. This process yields various indicators of value (commonly, one each based upon book value, earnings, cash flow, dividend-paying capacity, and potentially, industry specific valuation ratios). The weight or importance of each indicator depends on its relative significance. For example, earnings and cash flow are usually the most important indicators of value in the case of a manufacturing or service company. Book value and net assets are commonly important indicators of value in the case of an asset-rich holding company. Once the appraiser applies the pertinent ratios, a per share, freely traded value is derived. Absent merger & acquisition activity for the guideline companies, most analysts view the resulting value indication to be on a minority interest basis. The per-share, freely traded value may then be reduced by an appropriate allowance for lack of marketability.

iii. Asset-Based Approach

Under the asset-based approach, an entity's value is determined by subtracting its liabilities from the fair market value of its underlying assets. Thus, the aggregate net asset value of an entity's assets determines the entity's value. The asset-based approach is typically applied to entities without an active business, such as holding entities or entities engaged in investment activities. These entities typically produce relatively little income compared to the fair market value of the underlying assets, making these entities particularly amenable to this type of valuation. An important assumption about the asset-based approach is that the willing buyer purchases the entity to obtain ownership of the entity's underlying assets.[57] This assumption holds true because the value of the entity is not determined from the entity's income producing capacity; instead, the entity's assets provide the value.

The asset-based approach is defined by the American Society of Appraisers as "a general way of determining a value indication of a business, business ownership interest, security or intangible asset using one or more methods based directly on the value of the assets net of liabilities."[58] The asset-based approach comprises two primary methods, the net asset value method and the liquidation value method. The major distinction between these two methods is a difference in the underlying premises of each. The net asset value method assumes that the business is a going concern, while the liquidation value method assumes that the value of the assets will be realized through a forced or orderly liquidation of its assets. The asset approach is particularly relevant in valuing investment holding companies and asset-rich companies. Revenue Ruling 59-60 notes "that adjusted net worth should be accorded greater weight in valuing stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend-paying capacity."[59] Accordingly, the asset-based approach has received significant attention in recent years as the primary means for valuing family limited partnerships and other investment holding vehicles.

1. Advantages of the Asset-Based Approach

    a. Easy to understand both in theory and in application.

    b. The approach is well-suited for the valuation of a failing industrial or service company, especially in the context of a controlling interest valuation (when the business is worth

[57] *See Estate of Dunn*, 301 F.3d at 353; *Estate of Cruikshank v. Comm'r*, 9 T.C. 162, 165 (1947).
[58] Business Valuation Standards (2009), at 9.
[59] Rev. Rul. 59-60, 1959-1 C.B. 237.

more as the total of assets less liabilities than as an operating entity).

c. This approach may also be useful when the entity being valued has no history of earnings.

2. Disadvantages of the Asset-Based Approach

a. The approach requires competent appraisals or assessments of the fair market value of the assets and may therefore necessitate the use of other appraisers. Verification and collectability of accounts receivable and inventory evaluations may be required.

b. In the context of a going concern value, the asset-based approach generally disregards earnings, except to the extent competent intangible asset appraisals are incorporated into the valuation process.

3. Steps in Preparing the Asset-Based Approach

a. Obtain a balance sheet for the entity as of the date of valuation.

b. Review the balance sheet to ascertain those assets and liabilities that require a revaluation adjustment and adjust the historical book values on the balance sheet to the fair market value of those assets and liabilities.

c. Identify and incorporate into the analysis all material off-balance sheet assets and liabilities.

d. Value the assets and liabilities and incorporate the fair market value of these balance sheet items to the adjusted balance sheet.

e. Depending on the type of value for the particular assignment (*i.e.*, marketable minority, marketable control, etc.), adjust the value derived by a marketability discount. Generally, a control premium would not be meaningful under this approach.

iv. Multiple Approaches

It is appropriate to use multiple valuation approaches in some situations. Some entities will have both operating and investment components; guideline transactions might reflect some components of an entity yet be inapposite to others. In such cases, courts permit a combination of the

approaches to value the entity's respective components.[60] Under this hybrid approach, courts will rely on expert testimony to value the components. If the components can be easily segregated, the components can be independently valued; where the components are intertwined, expert testimony will determine the weight to be placed on the respective components.

d. Supporting the Allowances[61]

i. Allowance for Lack of Control (Minority Interest Discount)

The American Society of Appraisers defines minority interest discount as "a discount for lack of control applicable to a minority interest."[62] A minority interest may be defined as an "ownership interest less than 50% of the voting interest in a business enterprise." [63]

The minority interest discount should be based on an analysis of the specific facts and circumstances related to the business or business interest being valued, as courts will base their opinions on an analysis of factors influencing a minority interest discount.

The essential question that must be answered in the process of supporting the existence and the quantification of a minority interest discount is: What rights and benefits does the minority interest holder possess? The rights and benefits that a minority interest holder possesses may be ascertained by identifying the elements (prerogatives) of control, if any, held by the minority interest owner. Commentary has suggested some of the more common prerogatives of control:

1. Appoint management.

2. Determine management compensation and perquisites.

3. Set policy and change the course of business.

4. Acquire or liquidate assets.

5. Select people with whom to do business.

6. Make acquisitions.

[60] S*ee Estate of Andrews v. Comm'r*, 79 T.C. 938, 944 (1982), *superseded by statute on other grounds*, Tax Reform Act of 1986, Pub. L. No. 99-514 § 613, 100 Stat. 2085, *as recognized in Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998); *Estate of Ford v. Comm'r*, 66 T.C.M. (CCH) 1507, 1520 (1993), *aff'd*, 53 F.3d 924 (8th Cir. 1995); *Estate of Gallun v. Comm'r*, 33 T.C.M. (CCH) 1316, 1320 (1974), *superseded by statute on other grounds*, Tax Reform Act of 1986, Pub. L. No. 99-514 § 613, 100 Stat. 2085, *as recognized in Eisenberg*, 155 F.3d 50; *Estate of Thalheimer v. Comm'r*, 33 T.C.M. (CCH) 877, 910-11 (1974).
[61] *See, e.g., McCord v. Comm'r*, 120 T.C. 358 (2003), *rev'd,* 461 F.3d 614 (5th Cir. 2006); *Lappo v. Comm'r*, 86 T.C.M. (CCH) 333 (2003).
[62] Business Valuation Standards (2009), at 30.
[63] *Id.* at 29.

7. Liquidate, dissolve, sell out, or recapitalize the company.
8. Sell or acquire treasury shares.
9. Register the company's stock for a public offering.
10. Declare and pay dividends.
11. Change the articles of incorporation or bylaws.
12. Block any of the above actions.[64]

Additional criteria that may affect the quantification of a minority interest discount include:

1. Applicable state law affecting minority rights.
2. Corporate articles and bylaws.
3. Other rights and restrictions agreed to by the parties.

ii. Empirical Evidence from Which to Establish Minority Interest Discounts

First, business interests valued by the guideline company method inherently represent a value on a minority interest basis. This is because the stocks of the guideline companies generally trade as minority interests. Therefore, the valuation multiples derived from these companies are considered to be on a minority interest basis.

In the context of private investment holding entities such as family limited partnerships, minority interests are derived by an analysis of capital market evidence that corresponds to the nature of the assets held by these entities. For marketable securities, the capital market evidence may be found by an analysis of the market value to net asset value relationships of publicly traded, closed-end investment companies. For real estate assets, the capital market evidence may consist of the market value to net asset value relationships of publicly registered partnership units. Interestingly, the IRS has embraced the use of publicly traded, closed-end funds for valuing private investment companies.[65]

For the valuation of a minority interest in a closely-held entity with voting and nonvoting securities, the discounts applicable to nonvoting shares may also be quantified by reference to the capital markets. In order to support the discount differential between the voting and nonvoting classes of stock, public analogs with pure voting and nonvoting capital structures, or supervote/low-vote securities, should have fluid markets in each class.

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[64] Pratt, Shannon P., Reilly, Robert F. and Schweihs, Robert P. *Valuing a Business (3d ed.),* at 301.
[65] Commerce Clearing House, Inc., *IRS Valuation Training for Appeals Officers* (CCH 1998), at 11-10.

iii. Lack of Marketability

A marketability allowance is an amount or percentage deducted from an equity interest to reflect lack of marketability. Lack of marketability may be defined "as the absence of a ready or existing market for the sale or purchase of the securities being valued"[66] and as "the ability to convert the property to cash quickly, with minimum transaction and administrative costs in so doing, and with a high degree of certainty or realizing the expected amount of net proceeds."[67] As with the other components of the final value conclusion, the discount for lack of marketability should be based on the appraiser's own research and analysis. Because the discount for lack of marketability may have the greatest effect of any valuation factor, it is essential that the support for this discount be formulated and presented in a convincing and persuasive manner.

iv. Empirical Evidence, Lack of Marketability Discounts

The empirical evidence historically used to support lack of marketability discounts applicable to minority interests has taken the form of two major and differing analyses: restricted stock studies and initial public offering studies. Flotation studies represent empirical evidence that is germane to substantiating lack of marketability for controlling interests in privately held entities.

In recent years the depth and extent of the empirical evidence to support marketability discounts has increased incrementally. This is attributable to the rapid development of the business appraisal profession and the fact that users of business valuations (*e.g.*, Tax Court judges, IRS personnel and others) have become significantly more sophisticated. The IRS Discount for Lack of Marketability Job Aid that was published in 2009[68] is evidence of this trend.

1. Flotation Studies

The cost of flotation method to substantiate an allowance for lack of marketability is based on the premise that an initial public offering is an option available to a controlling equity holder in a privately held business, thus achieving marketability for the interest. Because the ability to complete an initial public offering is available only to a shareholder that holds more than 50% of the voting equity in an entity, the cost of flotation method is most relevant to measure the lack of marketability of a controlling interest. However, flotation studies can provide a reference point

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[66] *Id,* at 9-3.

[67] Pratt, *Valuing a Business (3d ed.)*' at 332.

[68] Internal Revenue Service Engineering/Valuation Program DLOM Team, *Discount for Lack of Marketability Job Aid for IRS Valuation Professionals*, September 25, 2009.

for the consideration of an allowance for lack of marketability related to a minority interest.

2. Restricted Stock Studies

The restricted stock studies are based on transactions of SEC Rule 144 restricted stocks. Restricted stock is commonly referred to as "letter" or unregistered stock. An unregistered stock is identical to the registered stock of a public company except that the letter stock is restricted from trading on the open market for a certain time period. From time to time, unregistered shares are sold in private transactions. Because the unregistered shares are not immediately marketable in the established market for registered shares, such transactions generally occur at prices below the concurrent market prices of the actively traded shares. These private transactions enable appraisers to compare the prices of shares that may not be immediately traded in public markets with the prices of otherwise identical shares in the same company that may be immediately traded in the established public market. Thus, transactions in unregistered shares provide a useful guideline as to the diminution in value arising from the lack of ready marketability. Over the years, a number of studies of unregistered shares have been used by appraisers as evidence to support lack of marketability discounts.

Often, these studies are cited as the sole support for a material reduction in value for the lack of marketability. Certain seminal works, some 30 plus years old by now, are cited with regularity. Some restricted stock studies may inherently reflect factors other than impaired marketability in that many of the largest discounts are witnessed in start-up companies, lacking a track record, or failing, money-losing concerns.

3. Initial Public Offering ("IPO") Studies

The IPO studies compare transactions of stock of companies that were private at the time of the transaction, but subsequently went public. The lack of marketability discount is generally determined by measuring the difference in the IPO issue price and the price that the stock traded in transactions prior to the IPO.

The IPO studies generally indicate higher lack of marketability discounts than those derived from the restricted stock studies. The IPO studies have been criticized because the discounts so derived are skewed to the high side for two reasons:

a. The transactions preceding the IPO are presumed to have occurred at fair market value in arms' length transactions.

b. Many IPO companies have rapidly growing earnings and, therefore, increasing values.

4. Long-Term Equity Anticipation Securities ("LEAPS®")

Some recent research to support marketability allowances for minority interests in privately held entities involves long-term equity anticipation securities. A longer term version of the typical put option, LEAPS® offer the purchaser the option, but not the obligation, to lock in a price for up to two years, as a type of "insurance policy." LEAPS® are analyzed in this context because one of the penalties of lack of marketability inherent in a minority interest in a privately held business is the inability to dispose of the investment in the event of a price decline, a change in the fundamental outlook for the underlying business, or for any other reason. A protective put option or LEAPS® can eliminate the risk of a price decline, for a fee equal to the cost of the option.

5. Quantitative Methods

Quantitative methods attempt to support an allowance for lack of marketability based on assessments of factors that may be considered by market participants using quantitative inputs for the specified factors. These criteria include capital appreciation, dividend yield, term of investment, prospects for liquidity, and required holding period. In theory, quantitative methods are conceptually sound.[69] However, the practical application of a quantitative method typically involves numerous assumptions that tend to erode the reliability of the derived conclusion.

6. Rate of Return Studies

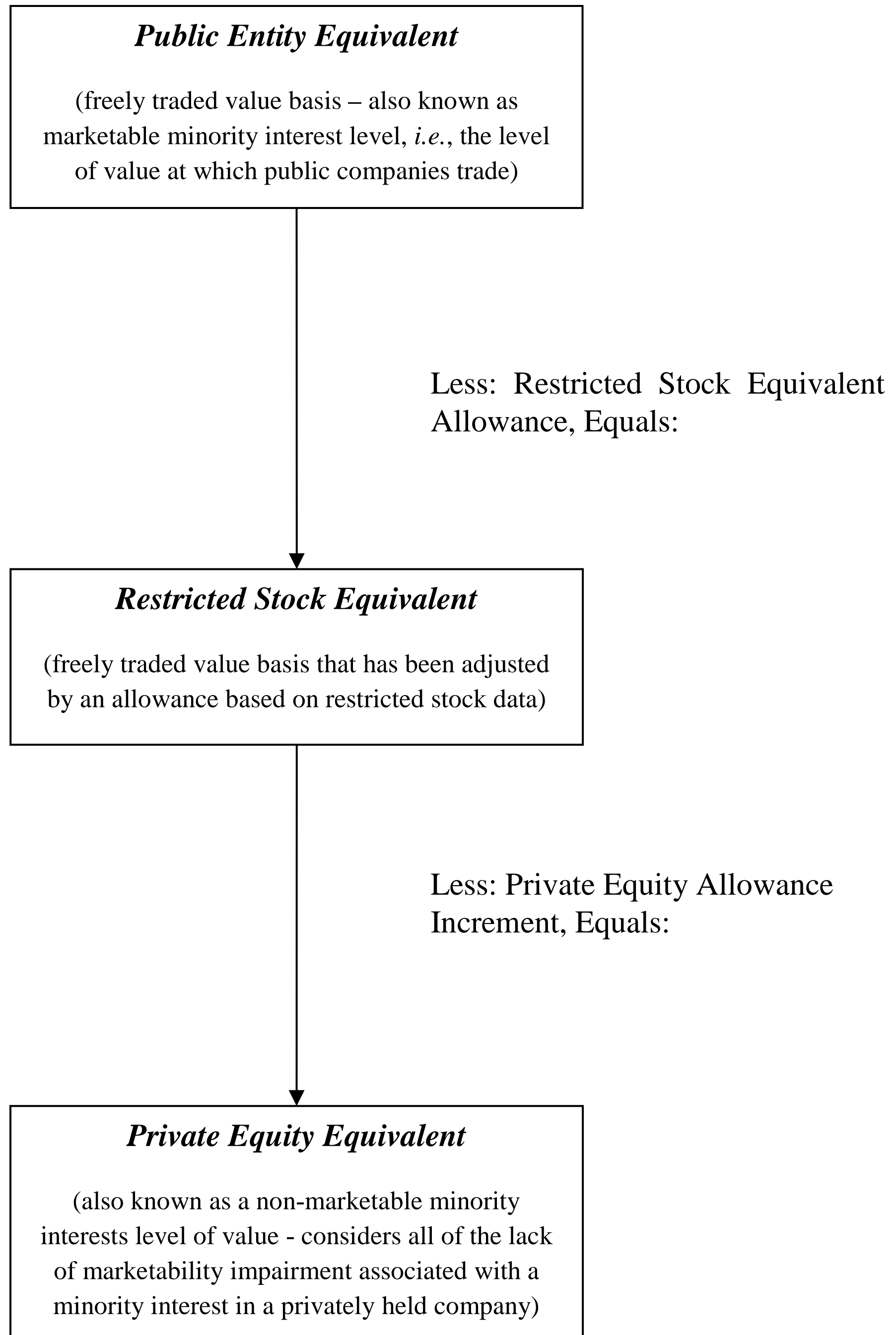
Another example of some recent research with respect to substantiating lack of marketability allowances involved three separate studies as follows: 1) private equity returns vs. public equity returns, 2) restricted stock returns, and 3) long-term vs. short-term bond returns. These studies are collectively referred to as the rate of return studies. The key question posited by these studies is: How much should the investor's effective rate of return

[69] Importantly, quantitative methods rely on the concept of the time value of money. For example, the present value of $100 to be received 5 years from now is about $62.09, using a discount rate equal to 10% compounded annually. Quantitative methods use an assumed holding period, at which time the asset with impaired marketability will become marketable in the future. The future value of the proceeds is converted to a present value using a risk adjusted rate of return, or discount rate. The allowance for lack of marketability is the reduction in the value of the asset. In the example above, the indicated allowance for lack of marketability would be 37.91%.

be increased to compensate for lack of marketability? Overall, the three research studies suggest that investors require a 30% to 40% increase in their rate of return above a marketable interest when an interest is not marketable.

v. The Private Equity Allowance Increment

In recent years, business valuation practitioners have begun to address the discrepancy between the capital market evidence available that reflects impaired marketability and its applicability of supporting lack of marketability allowances for minority interests in privately held business entities. In most instances, the discussion of this issue has been framed from the perspective of adjusting a conclusion derived from restricted stock data to an allowance that accounts for the factors addressed, which then may be used to convert a freely traded minority interest basis value to a private equity minority interest basis. These relationships may be graphically presented as follows:



At this point in time, the research on this specific topic of business valuation has been limited.

vi. Investment Attractiveness Discounts

This valuation allowance considers the public guideline companies (or any market-based benchmark entity) and the relative attractiveness of the subject entity against various criteria. These criteria may include size, diversification, management depth, key customers or accounts, growth rate differentials, and contingencies. This adjustment may either be downward (discount) or upward (a premium).

vii. Discounts for Undivided Interests in Real Estate

A discount for an undivided interest in real estate is associated with the lack of control, lack of marketability and costs of partition of an ownership interest of less than 100%. In theory, the most relevant evidence to consider in support of a discount for an undivided interest in real estate would be an analysis of similar sales of undivided interests. However, there are two major problems with using similar sales of undivided interests in support of such a discount. First, arm's length sales are virtually nonexistent in many markets. Second, a reliable valuation of the fee simple interest must be known in order to quantify the magnitude of the discount. Because of these obstacles, business appraisers are frequently called on to support discounts for undivided interests in real estate by measuring the impact of lack of control and lack of marketability of these interests. The costs and time to partition an undivided interest in real estate are commonly used to supplement the lack of control and lack of marketability analysis to corroborate the overall discount.

viii. Built-in Gain Discounts

As a result of the repeal of the *General Utilities* doctrine, an acquirer purchasing all of the stock of a corporation for a price that exceeds the acquired corporation's cost basis for its assets does not receive a stepped-up basis for those assets. They carry built-in capital gains that will be taxable at the time the assets are sold. Built-in gains can be of particular significance in valuing the stock of real estate or securities investment companies because the value of their stock is heavily influenced by the value of their underlying net assets. When those assets carry substantial unrealized capital gains, an informed buyer of the investment company will adjust the price downward to allow for the corporate capital gains tax attributable to the unrealized gains. Such an adjustment is necessary in order to keep the effective cost of the assets equivalent to the cost they would have had if purchased directly. (Assets purchased directly would have a cost basis equal to their purchase price and therefore would incur a lesser capital gains tax when subsequently sold.) The economic facts should be clearly recognized and allowed for when determining the fair market value of the stock of a closely held investment company whose assets have unrealized capital gains.

ix. Blockage Discounts

A blockage discount arises when substantial amounts of traded stock are introduced into the marketplace resulting in a drop in value. The amount of the discount is determined by consideration of various factors, including the quoted price of the security, the amount of stock and its degree of activity, market depth, size of the block of stock, time and market trends.

x. Key Person Discounts

In many closely held companies, the contribution of one or more individuals is of such significance that the loss of the individual(s) may have an adverse effect on the value of a company. The amount of the discount is contingent on the involvement of the individual and how readily the key person's skills, client relationships and knowledge can be replaced. Key person issues are addressed in Revenue Ruling 59-60: "The loss of a manager of a so called 'one-man' business may have a depressing effect on the value of the stock of such business, particularly if there is the lack of trained personnel capable of succeeding to the management of the company."[70]

xi. Market Absorption Discounts

Frequently a real estate holding entity has significant real estate holdings that would depress the market if disposed of within a short period of time. In such cases, a discount for market absorption may be appropriate. Commonly, this discount is considered by the real estate appraiser responsible for the value of the underlying real property assets of the entity. Thus, the discount is reflected within the net asset value of an investment holding company before the business appraiser is involved.

2. Definition of Qualified Appraisal

a. Legal Authority

Generally, a qualified appraisal is one "conducted by a qualified appraiser in accordance with generally accepted appraisal standards."[71] However, there is no actual definition of a qualified appraisal for gift tax purposes. The adequate disclosure regulations, as further discussed below, provide some significant guidance as to what the qualification of the appraiser and the content of the appraisal should be in order to satisfy the adequate disclosure requirements.

Other provisions of the Code provide definitions that are useful by analogy, including Treas. Reg. § 1.170A-13(c)(3) (regarding qualified appraisals of

[70] Rev. Rul. 59-60, 1959-1 C.B. 237.
[71] Pension Protection Act of 2006, Pub. L. No. 108-280, § 1219(c)(1)(E)(i)(II), 119 Stat. 1937.

transfers for purposes of the income tax charitable deduction) and Treas. Reg. § 1.468B-3 (regarding qualified appraisals of transfers to qualified settlement funds).

b. Other IRS Guidance Related to Business Valuations

i. IRS Valuation Training for Appeals Officers

The latest version of this guidance was issued in May of 1997. It is designed primarily to benefit IRS officials who negotiate settlements of income, estate and gift tax cases in which the valuation of real or personal property is necessary, but it also gives taxpayers and tax advisors a valuable insight into the major valuation problem areas and the accepted methods and approaches applied by IRS Appeals Officers in considering valuation questions.

ii. UIL 2031.01-00, Appeals Coordinated Issue Settlement Guidelines, Discounts for Family Limited Partnerships

This guidance was issued on January 31, 2007. It focuses on four issues as follows: discounts for transferred interests; whether inter vivos transfers should be included in the estate under § 2036 or § 2038; indirect gifts of an entity's underlying assets; and whether accuracy-related penalties under § 6662 are applicable. It should be noted that the public version of this document has been sanitized, with many sections blacked out for public review.

iii. IRS Office of the General Counsel Notice CC-205-001, Tracking for Abusive Tax Shelters

This guidance was issued on November 29, 2004. As most practitioners working with valuations are aware, family limited partnerships have been heavily scrutinized by the IRS for many years. This notice added formality to this level of scrutiny. Family limited partnerships are classified as "Other Abusive Transactions."

iv. Internal Revenue Manual (IRM) 4.48.4, Engineering Program, Business Valuation Guidelines

The purpose of this manual, issued on July 1, 2006, is to provide guidelines applicable to all IRS personnel engaged in valuation practice relating to the development, resolution and reporting of business valuations and similar valuation issues. Importantly, the IRS personnel engaged in valuation practice must reasonably justify any departure from the guidelines contained in this document.

v. IRM 8.18.1, Valuation Assistance Procedures

This document, issued on March 30, 2001, describes the procedures for Internal Revenue Service personnel in requesting valuation assistance from Appeals Appraisal Services.

c. Professional Appraisal Organization Guidance

i. Uniform Standards of Professional Appraisal Practice ("USPAP")

The Appraisal Foundation promulgates USPAP. The Appraisal Foundation is comprised of several professional appraisal organizations. The members of these appraisal organizations that comprise The Appraisal Foundation must adhere to USPAP. The purpose of USPAP is to promote and maintain a high level of public trust in appraisal practice by establishing requirements for appraisers. Although compliance with USPAP is not mandatory for appraisals of business interests for federal tax purposes unless the appraiser is a member of one of the Appraisal Foundation organizations, USPAP does represent sound guidelines for appraisal practice and reporting. Of particular note in the context of valuations prepared for federal tax purposes is the Tax Court's reference to USPAP in a Tax Court Memorandum opinion,[72] where the Court was critical of one valuation expert who did not prepare his report in accordance with USPAP. Importantly, the previously referenced IRS Notice 2006-96 includes reference to USPAP as an example of what constitutes generally accepted appraisal standards for appraisals prepared for noncash charitable contributions. (USPAP Standards 9 & 10, which pertain to business appraisals, may be obtained at the Appraisal Foundation web site at www.appraisalfoundation.org.)

ii. American Society of Appraisers Standards on Business Valuation

The American Society of Appraisers ("ASA") is an independent multi-disciplinary appraisal organization whose goal is to maintain and elevate the standards of the appraisal profession. The standards on business valuation provide minimum criteria to be followed by business appraisers in the valuation of businesses, business ownership interests and securities. Although ASA standards are not authoritative for estate and gift tax valuations, they also represent standards of good appraisal practice and do govern the practice of ASA members.

iii. American Institute of Certified Public Accountants Standards

In June 2007, the American Institute of Certified Public Accountants ("AICPA") published AICPA Statement on Standards for Valuation Services No. 1 (SSVS No.1) "Valuation of a Business, Business

[72] *Kohler v. Comm'r*, 92 T.C.M. (CCH) 48 (2006).

Ownership Interest, Security or Intangible Asset." SSVS No. 1 applies to valuation services provided by CPAs for engagements accepted on or after January 1, 2008.

iv. National Association of Certified Valuation Analysts Standards

The National Association of Certified Valuation Analysts (NAVCA) was formed in 1991. NAVCA focuses on training, accrediting and providing resources for business valuation and litigation support professionals. NAVCA has established standards of practice for business valuation for its members.

3. Critical Elements of the Appraisal

a. Cover Letter

The appraisal should include a summary cover letter that states and explains the following:

i. The retaining party and other intended users.

ii. The standard of value definition and source.

iii. The "as of" date for the valuation.

iv. The purpose of the valuation and intended use.

v. The legal nature of asset and interest being valued.

vi. A summary of the transferred interest's rights to control or lack thereof.

vii. A summary of the transferred interest's access to a ready market necessary for liquidity.

viii. A summary of the scope of work.

ix. A summary of information considered.

x. A summary of methodologies used.

xi. Caveats or hypothetical conditions.

xii. Value conclusion.

xiii. A summary of references to the adequate disclosure rules.

xiv. Appraiser's signature.

b. Body of Report

The body of the appraisal should contain exhaustive analysis that includes the following:

i. Standard of value.

ii. Purpose of valuation.

iii. Description of interest being valued.

iv. Prior transactions involving transferred interest.

v. Caveats or hypothetical conditions.

vi. Rights, preferences, and privileges of transferred interest.

1. Description of all interests (debt and equity).

2. Specific Rights, Preferences, and Privileges of Interest.

a. Statutory

i. Provisions of substantive corporate or partnership law.

ii. Other substantive restrictions on the transfer of the underlying assets.

b. Contractual

i. Articles of incorporation.

ii. Corporate by-laws.

iii. Operating/partnership agreement.

iv. Rights of first refusal.

v. Buy/sell agreement.

c. Economic

i. Key person.

ii. Blockage/market absorption.

iii. Black-out provisions.

iv. Subchapter S tax premium.

v. Influence.

vi. Lack of control.

vii. Lack of marketability/liquidity.

vii. Economic overview.

viii. Entity specific information.

ix. Methodologies used to determine fair market value.

x. Value conclusion.

xi. Signed certification (USPAP Standards Rule 10-3).

xii. Statement of qualifications.

xiii. Exhibits.

c. Further Considerations

i. Beware of Rounding on Appraisals and Tax Returns

If there is a reason to round value up or down, be sure that the appraiser explains his reasons in the appraisal. If the appraiser cannot explain why the value should be rounded up or down, he likely will not be able to do so on the stand either. And the courts are increasingly examining and parsing practically each and every valuation conclusion of appraisers of limited partnership interests. Unexplained rounding may cause a court to question other conclusions that the appraiser has made in the appraisal.

ii. The appraisal should be written in a manner that effectively communicates its content and conclusions to its likely readers, *i.e.*, IRS personnel and, potentially, judges.

4. Understanding Adequate Disclosure Regulations

a. Adequate Disclosure and Statute of Limitations

Adequate disclosure of a gift or non-gift transfer is fundamental to commencing the statute of limitations. In the absence of adequate disclosure, a gift tax may be assessed with respect to the transfer at any time. (In other words, the statute of limitations does not begin to run with the filing of an estate or gift tax return without adequate disclosure.)

The statute of limitations applicable to assessment of the gift tax is generally three years as provided by § 6501(a). However, if the return omits an amount of gifts that exceeds 25 percent of the total amount of gifts reported on the return, the statute of limitations is extended to six years. If no return is filed or if the filed return is false or fraudulent (or if adequate disclosure is not made), the statute of limitations remains open indefinitely.

Because of the 25 percent substantial understatement rule, practitioners should be sensitive to making sure that all gifts are adequately disclosed, even including those made to charity.

b. Disclosure Requirements for Completed Gifts

A transfer will be adequately disclosed on the gift tax return only if it is reported in a manner adequate to apprise the IRS of the nature of the gift and the basis for the value so reported. Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed under the Regulations if the return or a statement attached to the return provides the following information:[73]

i. A description of the transferred property and any consideration received by the transferor.

ii. The identity of, and relationship between, the transferor and each transferee.

iii. If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the terms of the trust, a copy of the trust instrument.

iv. A detailed description of the method used to determine the fair market value of property transferred, including:

1. Any financial data that were utilized in determining the value of the interest (for example, balance sheets, etc., with explanations of any adjustments).

2. Any restrictions on the transferred property that were considered in determining the fair market value of the interest.

3. A description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability.

4. In the case of an entity that is not actively traded, a description must be provided of any discount claimed in valuing the interest in the entity or assets owned by such entity.

[73] Treas. Reg. § 301.6501(c)-1(f)(2).

5. If the transferred entity owns interests in other entities, similar information regarding the underlying entities must be disclosed.

v. A statement describing any position that is contrary to any proposed, temporary or final Regulations or Revenue Rulings published at the time of the transfer.

vi. An appraisal can satisfy the requirements as to the description of the method used to determine fair market value of the transferred property if certain conditions are met.[74]

1. The appraisal is prepared by an appraiser who satisfies all of the following requirements:

   a. The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis.

   b. Because of the appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education and membership, if any, in a professional appraisal association, the appraiser is qualified to make appraisals of the type of property that was transferred.

   c. The appraiser is not the donor or donee of the property or a member of the family of the donor or donee, or any person employed by the donor, the donee or a member of the family of either.

2. The appraisal contains all of the following:

   a. The date of the transfer, the date on which the transferred property was appraised and the purpose of the appraisal.

   b. A description of the property.

   c. A description of the appraisal process employed.

   d. A description of the assumptions, hypothetical conditions and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions and conclusions.

   e. The information considered in determining the appraised value, including in the case of an ownership interest in a

[74] Treas. Reg. § 301.6501(c)-1(f)(3).

business, all financial data that was used in determining a value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value.

f. The appraisal procedures followed, and the reasoning that supports the analyses, opinions and conclusions.

g. The valuation method utilized, the rationale for the valuation method and the procedure used in determining the fair market value of the asset transferred.

h. The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

c. Disclosure Requirements for Non-Gift Completed Transfers[75]

Completed transfers to members of the transferor's family that are made in the ordinary course of operating a business are deemed to be adequately disclosed, even if the transfer is not reported on a gift tax return, provided that the transfer is properly reported by all parties for income tax purposes. For example, in the case of salary paid to a family member employed in the family owned business, the transfer will be treated as adequately disclosed for gift tax purposes if the item is properly reported by the business and the family member on their income tax returns. For a step-by-step, Schedule-by-Schedule, review of a gift tax return, see Exhibit A. For a checklist of items necessary for adequate disclosure, see Exhibit B.

Any other completed transfer that is reported, in its entirety, as not constituting a transfer by gift will be considered adequately disclosed if the same information is disclosed with respect to the property if the transfer had been a gift and an explanation is provided as to why the transfer did not constitute a gift.

d. Disclosure of Incomplete Transfers[76]

Adequate disclosure of a transfer that is reported as a completed gift on the gift tax return will commence the running of the statute of limitations, even if the transfer is ultimately determined to be an incomplete gift. For example, if an incomplete gift is reported as a completed gift on the gift tax return and is adequately disclosed, the period for assessment of the gift tax will begin to run when the return is filed. Further, once the statute of limitations has expired, the transfer will be subject to inclusion in the donor's gross estate for estate tax purposes only to the extent that a completed gift would be so included.

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[75] Treas. Reg. § 301.6501(c)-1(f)(4).
[76] Treas. Reg. § 301.6501(c)-1(f)(5).

On the other hand, if the transfer is reported as an incomplete gift whether or not adequately disclosed, the statute of limitations does not begin running even if the transfer is ultimately determined to be a completed gift. In this case, the gift tax with respect to the transfer may be assessed at any time, up until three years after the donor files a return reporting the transfer as a completed gift with adequate disclosure.

e. Should a Sale Be Disclosed?

Erring on the side of caution, a taxpayer should adequately disclose a sale of a closely held entity to a grantor trust on a gift tax return even if there was no gift component to the transaction. If adequately disclosed, a sale transaction with a zero value gift will commence the statute of limitations for the IRS to review the transaction, meaning that once the limitations period passes, the values involved in the sale will be deemed to be "finally determined." Although a taxpayer may be reluctant to alert the IRS to a sale by filing a gift tax return, if, upon the taxpayer's death, the taxpayer's estate is required to file an estate tax return, the transaction will nevertheless be disclosed because Line 13e of Part 4 of Form 706 requires the disclosure of all transfers or sales of an interest in a partnership, limited liability company or closely held corporation to a grantor trust during the decedent's lifetime. If the taxpayer has already adequately disclosed the transaction on a gift tax return and the statute of limitations has passed before the estate tax return is filed and audited, the IRS will not be able to challenge the reporting of the sale transaction. Thus, it appears to be a better practice to disclose the sale on a gift tax return, rather than waiting for the filing of the estate tax return.

D. PREPARING TO RESPOND TO IRS AUDITS

1. Consider Bringing in Litigation Counsel

Once the audit begins, it is particularly helpful to involve litigation counsel sooner rather than later, even if litigation counsel does not meet with the IRS and only serves as a consultant to the taxpayer. Doing so allows the litigator to be involved from step one, assisting in determinations related to the assertion or waiver of various privileges, responsiveness of documents and information and consideration of the eventual burden of proof under § 7491.

2. Determine Whether a Document Destruction Policy Exists; If So, Suspend

Some corporate trustees and executors have document destruction policies. It has become advisable for attorneys whose clients are involved in litigation to ensure that their clients suspend document destruction policies. The consequence of

failure to do so may include sanctions against the attorney and the client for spoliation of evidence.[77]

3. Implement Your Own "Audit"

At this stage (or even before an IRS audit begins), it may be beneficial to your client to review the taxpayer's books and records to determine which issues the IRS may identify as problematic. Test the strengths and weaknesses of the planning, reviewing both the legal authorities (new and old) and any post-planning administration that may impact the analysis of the validity of the plan or entities within the plan.

Assess the strength of the IRS's position. Has the IRS obtained an appraisal? Or is the IRS relying only on an engineer's report? Is the examining agent in a position to review the merits of the case? Does the agent have authority to negotiate settlement? Or will you need to consider requesting a meeting with the agent's supervisor?

For a list of commonly asked questions, see Exhibit C.

4. Consider the Burden of Proof

Until the late 1990s, the burden of proof in a tax case fell on taxpayers. In other words, if a court could not decide who should win in light of the evidence, the taxpayer lost. For examinations beginning after July 22, 1998, however, it became possible for taxpayers in certain circumstances to shift the burden of proof to the IRS, so that if a court cannot decide who should win in light of the evidence, the taxpayer will win. Under § 7491, if a taxpayer (who is not a partnership, corporation or trust) maintains all required records under the Code and complies with the IRS's reasonable requests for documents, information, and interviews, the burden of proof shifts to the IRS, and, if a court is undecided, the taxpayer wins. Although cases in which a court weighs the evidence and still comes down on the fence are very rare, the IRS has, in recent years, been very reluctant to agree that taxpayers meet the factual requirements of § 7491.

5. Consider the Impact of Privileges

Various privileges apply in the context of estate planning, the most familiar of which is the attorney-client privilege (often referred to simply as "the privilege"). As discussed earlier, the privilege covers client communications made to the attorney with the purpose of seeking legal advice. Keep in mind that the privilege is the client's to waive, not the attorney's.

Also, as discussed above, the work-product doctrine protects an attorney's thoughts and work in preparation for litigation. Contrary to common

[77] *See, e.g.*, *Phoenix Four, Inc., v. Strategic Res. Corp.*, 2006 WL 1409413 (S.D.N.Y.); *Qualcomm Inc. v. Broadcom Corp.*, No. 05CV1958-B, 2008 WL 66932 (S.D. Cal. Jan. 7, 2008).

misconception, the work-product doctrine only begins to apply to an attorney's work that is done "in anticipation of litigation." The required level of anticipation varies by court, but it is clear that in many jurisdictions, a court action need not be imminent.[78] According to the Seventh Circuit, audit can be the antechamber to litigation, and thus, the work-product doctrine may apply to an attorney's work even during the audit process.[79] Courts have extended work product doctrine protection even to proposed transactions. Recently, one district court found that the work product doctrine applied to tax accrual work papers of a company because the company's counsel believed that certain transactions entered into by the company would eventually be challenged by the IRS.[80]

More recently, the U.S. Congress enacted a new federal privilege under § 7525 – the tax practitioner's privilege. This privilege applies only in non-criminal tax cases, and it protects from discovery communications that, if communicated to an attorney, would have been protected from discovery under the attorney-client privilege.[81] Note, however, that in some jurisdictions, the tax practitioner privilege has been interpreted not to cover advice related to tax return preparation.[82]

While privileges can be waived, and often waiver is highly recommended (particularly in cases where the IRS is asserting the application of § 2036 and/or penalties), beware of subject matter waiver. Once the privilege has been waived on a particular subject matter, that waiver covers all communications on that subject matter.[83] Unfortunately, you cannot just pick and choose to waive the privilege with regard to favorable documents.

6. Consider Whether Production of Privileged Information May Help Your Case

Various privileges may apply in any given situation – the attorney-client privilege; the work product doctrine; and the tax practitioner's privilege under § 7525. As discussed above, however, there are often times when, if appropriate, it is helpful if the taxpayer waives privileges, such that documents and information that would otherwise be protected from discovery are produced. This is particularly true in estate tax cases, where the best person with personal knowledge – the decedent taxpayer – is not available to testify. Beware, though, of subject matter waiver. In essence, you cannot pick and choose what to produce. If the taxpayer waives the privilege as to one document with regard to, for instance, formation purposes, you cannot refrain from producing another

[78] *See Adlman*, 68 F.3d 1495.
[79] *See Frederick*, 182 F.3d at 502.
[80] *Textron*, 507 F. Supp. 2d 138.
[81] "With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney." I.R.C. § 7525.
[82] *See Frederick*, 182 F.3d 496.
[83] *See* Fed. R. Evid. 502 (addressing effect of inadvertent waiver as well).

document on the same subject that may contain potentially harmful discussion as well.

7. Provide Responses to the IRS that Are True and Correct, to the Best of the Taxpayer's Knowledge

The taxpayer's duty is to provide responses to IRS requests that are true and correct to the best of the taxpayer's knowledge. Be precise when responding to the IRS. For instance, if the partnership owns primarily real estate, but has a small equity portfolio, be sure to disclose the existence of both (and in detail) when asked by the IRS for the assets of the partnership. It is also important to keep in mind that the examiner involved may not have the authority to negotiate a settlement. When determining how much information to reveal voluntarily, the strength of the IRS's position must also be considered.

8. Keep in Mind that Anything Stated or Written Can Be Treated as an Admission

It is important to keep in mind that a judge or a jury might eventually read what is written related to the taxpayer's planning. Anything stated or written to the IRS at this stage can be treated as an admission. Further, anything written to the appraiser or any expert may be discoverable by the IRS.

9. Produce Responsive Documents in the Taxpayer's Possession, Custody or Control

It is the taxpayer's duty to produce responsive documents in his possession, custody or control. Although documents held by the taxpayer's attorney, accountant or bank are likely to be construed as within his possession, custody or control, documents held by others may not. Be sure to consider the relationship between the taxpayer and the advisor in analyzing this issue.

However, the taxpayer need produce *only* those responsive documents in his or her possession, custody or control; generally, there is no need to *create* documents to respond to IRS requests. If necessary, indicate in responding to the IRS that the taxpayer has no such documents in his possession, custody or control that are responsive to the request.

10. Keep Careful Track of Documents and Electronic Files Produced to the IRS

Particularly if litigation counsel becomes involved at some point, it is helpful to have a precise record of the documents and electronic files that have been provided to the IRS, from inception of the audit through the close of discovery. In that regard, consider Bates-labeling every page produced to the IRS, such that there is a number associated with every page. Doing so also helps in the stipulations process, as each exhibit can be identified by Bates-label number, ensuring that everyone (including the judge) is literally on the same page.

11. Understand the IRS's Broad Summons Power

The IRS has a very broad power to summons any information, books and records that it deems necessary to carry out is mission. The IRS may examine or summons a laundry list of items and people for the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax."[84] As might be expected, however, this broad power is subject to traditional privileges.

12. File Protective Claims If Necessary

Keep in mind that sometimes resolution of estate tax issues may impact income tax issues related to the partnership or the estate. Be sure to analyze whether the resolution of the estate tax issue might come too late to file a claim for refund (Form 843) on the income tax side. If so, you may find it necessary to file protective claims for refund or administrative adjustment requests (AARs) if the partnership is a TEFRA partnership to protect rights to income tax refunds that may eventually be due.[85] Keep in mind the Variance Doctrine as you formulate your protective claims.

13. Consider Whether it is Feasible to Keep Partnership in Place

At least until the examination of the transfer tax return has been closed and the taxpayer's tax liability finally determined, it is better if the partnership remains in place. Although facts that occur after the valuation date are arguably irrelevant, the IRS does not hesitate to use those facts when doing so might increase the value of the transferred interest (and resulting transfer tax); and terminating the partnership could play into the IRS's hands in this regard.[86]

14. In the Estate Context, Beware of Distributing Entity Interests

Beware of advising your client executor to make distributions of partnership interests from the estate (or other estate assets for that matter) prior to receiving an IRS closing letter. Among other reasons, under § 6324, a special federal estate tax lien immediately attaches to the entire gross estate of a taxpayer at her death. Under 31 U.S.C. § 3713, an executor has personal liability to pay estate taxes to the extent that he or she has paid any debts of the decedent or made any distributions to beneficiaries of the estate prior to payment in full to the IRS of the estate tax owed. An executor may request a release of personal liability from the IRS under § 2204 upon the payment in full of estate taxes owed.

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[84] I.R.C. § 7602(a); *see also Richey*, 632 F.3d 559.
[85] *See* I.R.C. §§ 6031(a), 6222-6231.
[86] *See Estate of Bigelow v. Comm'r*, 89 T.C.M. (CCH) 954 (2005), *aff'd*, 503 F.3d 955 (9th Cir. 2007).

15. Treat Informal Interviews as Depositions

> Although interviews by the IRS can be quite informal, neither the taxpayer nor the advisors should be caught off guard. These interviews are, in essence, depositions. In order to ensure that any additional requests for documents and information are provided in writing, such interviews likely ought to be held at an advisor's office (that of the attorney or accountant), rather than at the taxpayer's office or home. Consider also having a court reporter present to ensure that the taxpayer's responses are not misconstrued.

16. Understanding the IRS's Settlement Guidelines

> In 2007, the IRS issued settlement guidelines for matters involving limited partnerships. In those guidelines, the IRS explained that its goal is to promote consistency of approaches across different jurisdictions and that its primary modes of attack on partnerships would be the indirect gift theory and § 2036, in addition to valuation.[87]

E. CONCLUSION

In conclusion, many of the suggestions considered here should assist estate planners to fine-tune interactions with clients to ensure that creation of an entity fits with and implements the client's goals, both tax and non-tax in nature. A practical approach that the courts seem to rely on, whether explicit or implicit, is the smell test. Does the transaction "smell bad" or "look bad"? Use your olfactory senses to assist the client in addressing his or her needs in the most tax-efficient manner, all the while keeping in mind that anything you say or write may be discoverable (despite the attorney-client privilege). Work with your appraiser to ensure that he or she has all relevant information, thereby ensuring the most defensible appraisal. When done right, implementation of an entity can accomplish numerous client goals, while at the same time saving taxes. When done wrong, the same structure can save no taxes and cost the client time, money and emotional drain. To avoid this result, help your clients treat entities as the business structures that they are. And ensure that your appraisers understand the nature of the clients' businesses and goals.

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[87] *See* Settlement Guidelines, 07 No. 020 BNA Taxcore 25. *See, e.g., Lappo*, 86 T.C.M. (CCH) 333; *McCord,* 120 T.C. 358; *Peracchio v. Comm'r,* 86 T.C.M. (CCH) 412 (2003).

EXHIBIT A

1. Initial Considerations for Preparing Gift Tax Returns

    a. Reportable Gifts

    Any individual citizen or resident of the United States who makes a transfer by gift must file a gift tax return, unless such transfer is not includible in such individual's total amount of gifts for the year because the gifts are annual exclusion gifts[88] or qualified transfers[89], or transfers to the donor's spouse for which a marital deduction is allowed.[90] It is necessary to file a return to elect to gift-split, regardless of the amount of the gift.[91]

    In the case of present interest gifts made by a donor during the year, the first $14,000 of each gift in 2014 is not included in the total amount of gifts made during the year by the donor (also known as an "annual exclusion gift").[92] When the donee spouse is a non-U.S. Citizen, the donor may give up to $145,000 for 2014 as an annual exclusion gift that will not be subject to gift tax.[93]

    A qualified transfer also is not treated as a transfer of property for gift tax purposes.[94] A "qualified transfer" is a payment of tuition for the benefit of a donee paid directly to an educational institution, or the payment of medical care for the benefit of a donee paid directly to a medical care provider.

    When a donor transfers an interest in property to an individual, who at the time of the gift is the donor's spouse, a deduction is allowed in computing the donor's taxable gifts for the year in an amount equal to the value of the property transferred.[95]

    If the donor transfers property to an inter vivos QTIP trust for the benefit of his or her spouse, and wants to make a QTIP election with respect to such transfer, a return must be filed in order to make the election. Such an election can only be made on a timely filed return (including extensions).[96] If the donor dies during the same year of the transfer, the election must be made on a return filed no later than the due date of the Federal estate tax return (including extensions).[97] Because this election is prescribed by statute, as opposed to being a regulatory election, Section 9100 relief is unavailable to make a late QTIP election.[98]

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[88] I.R.C. § 2503(b).
[89] I.R.C. § 2503(e).
[90] I.R.C. §§ 2523 & 6019.
[91] I.R.C. § 2513.
[92] I.R.C. § 2503(b).
[93] I.R.C. § 2523(i)(2).
[94] I.R.C. § 2503(e).
[95] I.R.C. § 2523.
[96] Treas. Reg. § 25.2523(f)-1(b)(4)(i).
[97] Treas. Reg. § 25.2523(f)-1(b)(4)(ii).
[98] PLR 9641023 (July 10, 1996).

b. Party Responsible for Filing the Return

The donor is required to file the return.[99] If a donor is legally incompetent, his or her guardian may file a return on the donor's behalf.[100] Additionally, an agent of the donor may file the return on behalf of the donor. In order for an agent to file on behalf of a donor, the donor must be unable to file for himself by reason of illness, absence, or non-residence, and such return must be ratified by the donor when he becomes able to do so. An agent may not sign on behalf of the donor as a matter of mere convenience.[101] If the donor is deceased, the executor of the deceased donor's estate files the return on behalf of the donor for gifts made prior to the donor's death.[102] In addition, the executor may elect to gift-split on behalf of the donor.[103]

c. Due Date

i. General

The return may not be filed prior to January 1st of the year following the year in which the gift was made, and cannot be filed later than April 15th of such year, unless the appropriate extension of time to file is requested.[104]

ii. Out of the Country

If the taxpayer is considered out of the country on the regular due date of the return, April 15th, then the taxpayer's initial due date is the 15th day of the 6th month following the close of the taxable year, June 15th.[105] A taxpayer is considered "out of the country" if (a) he or she lives outside of the U.S. and Puerto Rico and his or her main place of work is outside of the U.S. and Puerto Rico or (b) he or she is in military or naval service outside of the U.S. and Puerto Rico.[106] It does not matter if the taxpayer is actually in the U.S. or Puerto Rico on April 15th.[107] A statement must be attached to the return explaining that the taxpayer is out of the country.[108]

iii. Extensions

If the taxpayer files Form 4868 to automatically extend the due date of his or her individual income tax return to October 15th, such extension will

[99] I.R.C. § 6019.
[100] Treas. Reg. § 25.6019-1(g).
[101] Treas. Reg. § 25.6019-1(h); Rev. Rul. 78-27, 1978-1 C.B. 387.
[102] Treas. Reg. § 25.6019-1(g).
[103] I.R.C. § 2513.
[104] I.R.C. § 6075(b).
[105] Treas. Reg. § 1.6081-5(a).
[106] Treas. Reg. § 1.6081-5(c).
[107] Treas. Reg. § 1.6081-5(e).
[108] Treas. Reg. § 1.6081-5(b)(1).

also automatically extend the time to file his or her gift tax return.[109] Note that an out of country taxpayer does not extend the time for filing for six months, but only extends the date for filing to October 15th. A taxpayer who does not qualify as an out of country taxpayer but expects to qualify as an out of country taxpayer has the ability to file Form 2350 to extend the time for filing to a date that is generally 30 days from the date that the taxpayer expects to qualify. As an exclusive alternative to filing Form 2350, an out of country taxpayer may request a discretionary two-month extension to file on December 15th by sending a letter to the IRS by October 15th, explaining the reasons for needing the extension. If the taxpayer expects to owe gift or GST tax, he or she must pay the estimated tax at the time of filing Form 4868.

If the taxpayer is not requesting an extension of time to file his or her individual income tax return, the taxpayer must request an extension of time to file his or her gift tax return by filing Form 8892. The filing of Form 8892 automatically extends the due date of the taxpayer's gift tax return to October 15th, but does not extend the time to pay the tax.

d. Where to File

i. Within the U.S.

Individuals located within the U.S. or the District of Columbia should file their returns in Cincinnati, Ohio at the following address:

Department of the Treasury
Internal Revenue Service Center
Cincinnati, OH 45999

ii. Private Delivery Service

Individuals using a private delivery service (*i.e.*, DHL, FedEx and UPS) should file their returns in Covington, Kentucky at the following address:

Internal Revenue Service
201 West Rivercenter Boulevard
Covington, KY 41011

e. Method of Payment

Payment of any gift (or GST) tax due can be made by personal check or money order payable to the "United States Treasury." The instrument should also bear the donor's social security number.

[109] I.R.C. § 6075(b)(2).

2. The Anatomy of the Return

This section of this outline describes the method of reporting gifts and the allocation of GST tax exemption on a gift tax return.

a. Page 1

i. Part 1–General Information

Part 1 is the General Information section in which the taxpayer provides the IRS with basic information, such as his or her name, social security number and address. In addition, the taxpayer answers various other questions. For example, the taxpayer will address whether the return was put on extension and whether he or she has previously filed a return. Part 1 also provides an area in which the taxpayer can elect to have the gifts made by him or her to third parties considered as gifted one-half by the taxpayer and one-half by the taxpayer's spouse. If the taxpayer elects to gift-split, his or her spouse is required to provide his or her social security number, where indicated, on Part 1 of the return and sign, where indicated, on line 18. The consenting spouse must also file his or her own return in order to report one-half of the gifts made by his or her spouse, unless only one spouse made a gift during the year and the value of such gift was less than two times the annual exclusion amount.

Line 19 was added to Part 1 to account for the deceased spousal unused exclusion amount ("DSUE Amount").[110] On line 19, the taxpayer should indicate if he or she has applied any DSUE Amount received from a predeceased spouse to any gift reported on the return or previous return and, if "Yes," then Schedule C must be completed, as described below.

ii. Part 2–Tax Computation

Part 2 of the return is the Tax Computation section, wherein the amount of taxable gifts is carried over from Schedule A among other amounts carried over from other Schedules, and the amount of tax due is calculated, taking into account the taxpayer's available applicable credit amount.

b. Schedule A: Computation of Taxable Gifts

Schedule A consists of Part 1—Gifts Subject Only to Gift Tax, Part 2—Direct Skips, Part 3—Indirect Skips and Part 4—Taxable Gift Reconciliation.

i. Valuation Discounts

The taxpayer must indicate in question A, located at the top of Schedule A, whether the value of any gift reported on Schedule A reflects

[110] I.R.C. § 2010(c)(4).

a discount of any kind, including, but not limited to, lack of marketability, fractional interest or minority interest discounts. If so, the taxpayer must attach an explanation giving the basis for taking such discounts.

ii. Qualified State Tuition Programs

If a taxpayer gifted cash to a qualified state tuition plan under Section 529 of the Code in excess of the annual exclusion amount on behalf of any individual beneficiary, he or she may elect to treat up to five times such amount of such contribution as made ratably over a five-year period, beginning in the year of the contribution. If the taxpayer elects to do so, he or she must check the box in question B, located at the top of Schedule A. A contribution to a qualified state tuition program on behalf of a designated beneficiary is considered to be a present interest gift and, thus, qualifies as an annual exclusion gift.[111]

c. Schedule A, Part 1–Gifts Subject Only to Gift Tax

The gifts to be reported on Part 1 are gifts that are only subject to gift tax and do not have the possibility of being subject to the GST tax at a later date. The taxpayer would provide the following information in each of the columns of Part 1:

i. Column A

The taxpayer must provide an item number for each of the gifts and provide the gifts in chronological order.

ii. Column B

The taxpayer must identify the donee's name and address, the relationship of the donee to the donor and a description of the gift. In addition, if the gift was made to a trust, the trustee's name and address, and the trust's Employer Identification Number ("EIN") must be provided, and the taxpayer must attach a copy of the trust to the return. If a security was gifted, such as a stock or bond, the taxpayer must provide the CUSIP number for such security. If the gift was an interest in a closely held entity, such entity's EIN must be provided.

iii. Column D

The taxpayer must provide his or her basis in the gifted property.

iv. Column E

The taxpayer must disclose the date that the gift was made to the donee.

[111] I.R.C. § 2503(b).

v. Column F

The taxpayer must disclose the fair market value of the gifted property as of the date of the gift. If a valuation discount was taken, such discount is reflected in column F. If the taxpayer is filing a return to report gifts of his or her spouse, which he or she elected to gift-split, and such taxpayer did not make any gifts during that year, column F would contain no values in the top part, but column F in the bottom part would include the taxpayer's spouse's gifts. In addition, one-half of the value of his or her spouse's gifts would be reported in column G.

vi. Column G

In column G, the taxpayer must disclose one half of the value reported in column F in cases in which the taxpayer has elected to split gifts with his or her spouse.

vii. Column H

In column H, the taxpayer must indicate the net transfer. If the taxpayer elects to split his or her gifts with his or her spouse, the gift is reduced by one-half of his or her gifts (this one-half is reported in column G).

d. Schedule A, Part 2–Direct Skips

Direct skips are reported on Part 2 of Schedule A. A "direct skip" is any transfer subject to estate or gift tax of an interest in property to a skip person, which may be an individual or certain trusts.[112] An individual is a "skip person" if he or she is two or more generations below the transferor's generation.[113] A trust is a "skip person" if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution be made to a person who is not a skip person.[114]

Other than the information required for column C of Part 2 described in the next paragraph, the information required to be disclosed in the other columns in Part 2 of Schedule A is the same as the information required to be disclosed in the corresponding columns of Part 1 of Schedule A. Any split gifts would be reported on Part 2 in the same manner as provided on Part 1 with regard to placing the information in the rows at the top or the rows at the bottom of Part 2.

An individual's GST exemption is automatically allocated to direct skips so that the inclusion ratio of such property is zero, exempting the transferred property from GST tax.[115] The taxpayer must use column C to indicate his or her intention of electing out of the automatic allocation of GST exemption. It should be noted

[112] I.R.C. § 2612(c).
[113] I.R.C. § 2613(a)(1).
[114].I.R.C. § 2613(a)(2).
[115] I.R.C. § 2632(b).

that it is necessary to attach an explanation to the return clearly describing the transaction and the extent to which the automatic allocation of GST exemption should not apply.

e. Schedule A, Part 3–Indirect Skips

Indirect skips are reported on Part 3 of Schedule A. An "indirect skip" is any transfer of property, other than a direct skip, that may be subject to gift tax and made to a GST trust.[116] A "GST trust" is any trust that could have a GST with respect to the transferor unless:

i. Age 46 Trust

The trust provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons (1) before the date the individual attains the age of 46; (2) on or before one or more dates specified in the trust that will occur before the date that such individual attains the age of 46; or (3) upon the occurrence of an event that, in accordance with regulations prescribed by the Treasury Secretary, may reasonably be expected to occur before the date that such individual attains the age of 46.

ii. Ten Year Age Difference Trust

The trust provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the trust who is more than 10 years older than such individuals.

iii. Partial Estate Tax Inclusion Trust

The trust provides that, if one or more individuals who are non-skip persons die on or before a date or event described in the first two exceptions, more than 25% of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals.

iv. Full Estate Tax Inclusion Trust

The trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer.

[116] I.R.C. § 2632(c)(3)(A).

v. Charitable Lead Annuity Trust and Charitable Remainder Trust

The trust is a charitable lead annuity trust, a charitable remainder annuity trust, or a charitable remainder unitrust.

The taxpayer's indirect skips are reported in the same manner on Part 3 as on Parts 1 and 2 of Schedule A, except for column C. The taxpayer uses column C of Part 3 to make an election regarding the allocation of GST exemption to the indirect gifts. Absent an election, an individual's GST exemption is automatically allocated to transfers to trusts from which a taxable distribution (*i.e.*, distribution to a skip person) or taxable termination (*i.e.*, when a trust no longer has any skip persons, and only has non-skip persons, remaining as beneficiaries of a trust) may occur.[117]

According to the 2012 Instructions for Form 709, by a check in column C next to the transfer to which the election will be made, the taxpayer may make three elections with respect to a transfer. Election 1 allows the taxpayer to elect not to have the automatic allocation rules apply to a current transfer made to a particular trust. Election 2 allows the taxpayer to elect not to have the automatic allocation rules apply to a current transfer made to a particular trust and all future transfer to that trust. Election 3 allows the taxpayer to treat any trust as a GST trust for purposes of the automatic allocation rules.

The taxpayer may elect out of the following transfers:

i. One or more prior-year transfers subject to Section 2642(f) of the Code regarding ETIPs made by the transferor to a specified trust or trusts;

ii. One or more (or all) current-year transfers made by the transferor to a specified trust or trusts;

iii. One or more (or all) future transfers made by the transferor to a specified trust or trusts;

iv. All future transfers made by the transferor to all trusts (whether or not in existence at the time of the election out); or

v. Any combination of the above.[118]

f. Manner of Election Out

The taxpayer must attach an "election out statement" to a timely filed return (whether or not a return is otherwise required). The election out statement must identify the trust (unless such trust is not in existence at the time of the election

[117] I.R.C. § 2632(c).
[118] Treas. Reg. § 26.2632-1(b)(2)(iii)(A).

out), identify the transfers to which the election out applies, and state that the taxpayer is electing out of the automatic allocation rules with respect to the transfer(s) described therein. Furthermore, any prior year transfer subject to Section 2642(f) of the Code must be identified.[119] In addition, unless the election out is made for all transfers made to the trust in the current year and/or in all future years, the current-year transfers and/or future transfers to which the election out is to apply must be specifically described or otherwise identified in the election out statement. The regulations contain examples of election out statements for various scenarios.

g. Termination of Election Out

If a taxpayer wants to terminate an election to not have the automatic allocation rules apply to any transfers made to a specific trust, the termination may be done on a timely filed return for the year in which the taxpayer wants the election to terminate (whether or not a return is otherwise required to be filed for such year).[120] A statement, referred to in the regulations as a "termination statement," must be attached to the return identifying the trust, describing the prior election that is being terminated and specifically providing that such election out is being terminated, and either describe the extent to which the prior election out is being terminated or describe any current-year transfers to which the prior election is not to apply.[121] It should be noted that a termination of an election out does not affect any transfer, or any election out, that is not described on the termination statement.[122]

h. Election Out of Automatic Allocation to an Indirect Skip Subject to an ETIP

A transferor may elect out of the automatic allocation rules with respect to a transfer subject to an ETIP by filing a return for any year within the ETIP; such return cannot be filed any later than the due date for the year in which the ETIP closes. The election out statement referred to above must identify any prior year transfers that are subject to 2642(f) and to which the election out is to apply. It should be noted that a return filed during an ETIP which purports to elect out of the automatic allocation rules for all future transfers will not apply to an allocation that is to occur at the close of an ETIP, unless such election out is specifically identified as described herein.

i. Election to Treat a Trust as a GST Trust

A taxpayer may elect to treat a trust, which is not a GST trust, as a GST trust (regardless of whether such trust is subject to an ETIP), so that the automatic allocation rules will apply to any current transfer(s), selected future transfer(s), all

[119] Treas. Reg. § 26.2632-1(b)(2)(iii)(B).
[120] Treas. Reg. § 26.2632-1(b)(2)(iii)(E).
[121] *Id.*
[122] *Id.*

future transfers made to such trust, or any combination thereof.[123] The taxpayer must attach a statement, referred to in the regulations as a "GST trust election statement," to a timely filed return for the year of the transfer (whether or not a return is otherwise required to be filed for such year) identifying the trust, describing the transfer, and specifically providing that the taxpayer is electing to have the trust treated as a GST trust.[124] This election may be terminated by filing a timely filed return for the year in which the taxpayer wants the election to terminate.[125] The taxpayer must attach a statement to the return identifying the trust, describing the transfer and providing that the prior election to treat the trust as a GST trust as provided is terminated.[126]

j. Schedule A, Part 4–Taxable Gift Reconciliation

i. Calculation of Taxable Gifts

On line 1 of Part 4, the taxpayer must provide the total amount of gifts as provided for in column H of Parts 1, 2 and 3 of Schedule A. The taxpayer must provide the total amount of his or her annual exclusion gifts, which would be the total of one-half of each annual exclusion gift, if the taxpayer's spouse consented to splitting the gifts for the year. Line 3 is for the value on line 1 less the value on line 2, totaling the amount of gifts subject to gift tax made by the taxpayer. Line 7 must contain the total amount of includible gifts.

ii. Deductions

The taxpayer accounts for any deductions applicable to the includible gifts on lines 4 through 8 of Part 4. On line 4, the taxpayer must indicate the total amount of his or her gifts to his or her spouse for which the taxpayer is claiming a marital deduction and has been reported in the items of Schedule A. Each item number of each such spousal gift, if any, must also be indicated. The amount of the annual exclusions that were claimed for the gifts on line 4 must be provided on line 5. Line 6 provides the difference between the amount of the gifts for which the marital deduction is being claimed and the amount of those gifts for which the annual exclusion is being claimed. On line 7, the taxpayer must disclose the total amount of charitable gifts (less any annual exclusion gifts) made and indicate the item numbers from Schedule A of those charitable gifts on the dotted line. Line 8 provides for the total amount of the taxpayer's deductions.

For example, gifts which qualify for the gift tax marital deduction would be provided on line 4. An example of such a gift would be a transfer to an

[123] Treas. Reg. § 26.2632-1(b)(3)(i)(A-D).
[124] *Id.*
[125] Treas. Reg. § 26.2632-1(b)(3)(iv).
[126] *Id.*

inter vivos trust for which QTIP treatment is elected. The taxpayer cannot take the marital deduction for gifts of terminable interests, where someone other than the donee will have an interest in the property following the termination of the donee spouse's interest, unless the interest meets the following requirements:

- Donee spouse is entitled to all income for life;
- Income is paid at least annually;
- Donee spouse has a general power of appointment; and
- No part of the interest is subject to another person's power of appointment.

If the donee spouse does not have a general power of appointment over the interest, the taxpayer may elect QTIP treatment so that the transfer qualifies for the marital deduction. The QTIP election is made by including such property on line 6 of Part 4 of Schedule A (checking a box to make such election is not necessary).

iii. Joint and Survivor Annuities

In the case of a joint and survivor annuity in which only the donor spouse and donee spouse have the right to receive payments before the death of the last spouse to die, the donor spouse is treated as electing QTIP treatment, unless he or she elects otherwise.[127] Accordingly, if a taxpayer purchased a joint and survivor annuity for a spouse (and only the donor spouse and donee spouse have the right to receive payments before the death of the last spouse to die) and such gift was reported on Schedule A by the donor spouse, the donor spouse could indicate on line 12 that he or she wishes to opt out of having such annuity automatically treated as QTIP property and indicate the item number from Schedule A of the annuity on the dotted line.

On line 9 of Part 4, the taxpayer provides the difference between his or her total taxable gifts from line 3 and deductions from line 8. Line 10 must contain the amount of any GST tax payable, as indicated in column H of Part 3 of Schedule D. The amount of the total taxable gifts must be indicated on line 11, which is the sum of the amounts shown on lines 9 and 10. The taxpayer also reports the amount of the total taxable gifts on line 1 of Part 2 of page 1 of the return.

[127] I.R.C. § 2523(f)(6).

k. Schedule B: Gifts from prior Periods

The taxpayer reports gifts from prior periods on Schedule B. In column A, the taxpayer reports the calendar year or quarter of a prior gift. In column B, the taxpayer provides the IRS office where the return was filed. In column C, the taxpayer indicates the amount of applicable credit (unified credit) used for such gift for gifts made after December 31, 1976. In column D, the taxpayer provides the amount of exemption used for gifts made before January 1, 1977. In column E, the taxpayer reports the amount of the taxable gifts for the corresponding year. Lines 1, 2 and 3 provide for the calculation of the total amount of taxable gifts from prior periods. The amount of those gifts is then carried over to line 2 of Part 2 on Page 1 of the return.

l. Schedule C: Deceased Spousal Unused Exclusion (DSUE) Amount

Schedule C has been inserted into the return to account for the inclusion of the "portability" of a DSUE Amount.[128] The concept of portability was introduced with the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 and made permanent with the American Taxpayer Relief Act of 2012.

In general, a deceased spouse who fails to fully utilize his or her applicable exclusion amount may have such unused exclusion amount "transferred" or "ported" to the surviving spouse.[129] The election must be effected on the deceased spouse's timely filed Form 706. Once ported, the surviving spouse may use the DSUE Amount at any time during his or her lifetime or upon his or her death.[130] The DSUE Amount usable by the surviving spouse is only the DSUE Amount received from his or her last deceased spouse.[131] For example, if a surviving spouse ("S") were to marry a new spouse ("N") and N also predeceases S, leaving S a smaller DSUE Amount than the unused DSUE Amount that S received from his or her first deceased spouse, or if N fails to leave S any DSUE Amount, S's unused DSUE Amount from the first deceased spouse is forever lost.[132]

An important clarification to the portability statutes was added in the Temporary Treasury Regulations promulgated in June 2012. Under the statutory scheme, as described above, it would be possible for a surviving spouse to lose a DSUE Amount if such spouse remarried and such new spouse also predeceased the surviving spouse leaving a smaller (or no) DSUE Amount.[133] Based on the transfer tax calculation methodology, it was potentially possible for a surviving spouse to utilize a DSUE Amount and then subsequently be taxed on such transfers if subsequently such surviving spouse received a smaller (or no) DSUE

[128] I.R.C. § 2010(c)(4).
[129] I.R.C. § 2010(c)(5).
[130] Treas. Reg. § 25.2505-2T.
[131] I.R.C. § 2010(c)(4).
[132] Treas. Reg. § 25.2505-2T.
[133] Treas. Reg. § 25.2505-2T(c).

Amount from a new spouse. The Regulations correct this by allowing a surviving spouse to receive full credit for the DSUE Amount utilized during life even if a subsequent spouse dies leaving a reduced (or no) DSUE Amount.[134]

Importantly, the "cost" of electing to transfer the DSUE Amount to the surviving spouse is that the IRS will have the opportunity to examine the deceased spouse's Form 706 until the end of the statute of limitations for the surviving spouse's estate, but only for purposes of reviewing the calculation of the DSUE Amount ported to the surviving spouse.[135]

i. Part 1–DSUE Received from Last Deceased Spouse

The taxpayer provides the information regarding the DSUE Amount from his or her most recently deceased spouse whose death occurred after December 31, 2010. Column A requires the name of the deceased spouse. The deceased spouse's date of death is provided in column B. In column C, the taxpayer must check "Yes" or "No" to indicate whether a portability election (meaning, the election to transfer the DSUE Amount to the surviving spouse) was made. If portability was elected, the taxpayer provides the amount of the DSUE Amount that was received in column D. In column E, the taxpayer provides the total amount of the DSUE Amount used by the gifts currently being reported and prior gifts (note that pursuant to the Treasury Regulations on portability, the DSUE Amount is used before the taxpayer's basic exclusion amount[136]).

ii. Part 2–DSUE Received from Predeceased Spouse(s)

On Part 2 of Schedule C, the taxpayer provides the DSUE Amounts used for each prior deceased spouse, if any, in separate rows. The information provided in columns A through F of Part 2 of Schedule C is similar to Part 1 of Schedule C.[137] The total DSUE Amount is required at the bottom of Part 2 above the number lines.[138]

The taxpayer calculates his or her applicable credit amount (which is the transfer tax calculation as applied to the taxpayer's applicable exclusion amount) using the numbered lines of Schedule C. The taxpayer's basic exclusion amount (in 2014, $5.34 million) is required on line 1. The total from column E of Parts 1 and 2 (that is inserted in the bottom box of Part 2) is provided on line 2. Line 3 is "Reserved" for later use by the Treasury and, thus, is inapplicable. Line 4 requires the sum of lines 1 and 2. Using the amount from line 4 and the Table for Computing Tax in the Instructions for Form 709, the taxpayer provides his or her applicable

[134] *Id*.
[135] Treas. Reg. §§ 20.2010-2T(d), 20.2010-3T(d), 25.2505-2 T(e).
[136] Treas. Reg. § 25.2505-2T(b).
[137] In column F of Part 2, the taxpayer provides the year of the gift using the DSUE Amount.
[138] This Part conforms to the provisions of Treas. Reg. § 25.2505-2T(c).

credit amount on both line 5 of Schedule C and line 7 of Part 2 on page 1 of the return.

m. Schedule D: Computation of Generation-Skipping Transfer Tax

i. Part 1–Generation–Skipping Transfers

All direct skips, whether or not such gifts qualify for the GST tax annual exclusion, are reported on Part 1 of Schedule D. In column A, the taxpayer lists the corresponding item number from column A of Part 2 of Schedule A. In column B, the taxpayer reports the value of the gift, as provided in column E of Part 2 of Schedule A. In column C, the taxpayer lists the nontaxable portion of the transfer (sometimes referred to as the "GST annual exclusion"), if any, for each gift listed in column B. The taxpayer then subtracts the amount in column C from the amount in column B and inserts the difference in column D. The rows of Part 1 of Schedule D are separated in a similar manner as the Parts of Schedule A, with the top rows for the taxpayer's gifts and the bottom rows for the spouse's gifts.

Note that a direct skip made to a trust will not qualify for the GST tax annual exclusion unless the trust meets the following requirements:

1. During the life of the trust beneficiary, no portion of the trust corpus or income may be distributed to or for the benefit of any person other than the beneficiary; and

2. If the trust does not terminate before the individual dies, the assets of the trust will be includible in the gross estate of the beneficiary.[139]

ii. Part 2–GST Exemption Reconciliation (Section 2631) and Section 2652(a)(3) Election

On line 1, the total applicable GST exemption amount must be indicated. On line 2, the total amount of such exemption used in prior periods must be listed. Line 2 is subtracted from line 1 and the resulting number (the exemption amount available for the current year's return) is listed on line 3. On line 4, the taxpayer indicates the amount of GST exemption allocated in column C of Part 3 of Schedule D, as described more fully below. On line 5, the taxpayer provides the amount resulting from automatic allocation of GST exemption to transfers reported on Part 3 of Schedule A.

If it is unclear whether the automatic allocation rules apply, in an abundance of caution, the taxpayer should attach a "Notice of Allocation"

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[139] I.R.C. § 2642(c).

to the return to ensure that the proper GST tax exemption is allocated. Moreover, some practitioners, as a matter of practice, always opt-out of the automatic allocation of GST exemption and allocate using a Notice of Allocation. If the taxpayer wants to allocate GST exemption to a transfer which is not a direct skip or to which the automatic allocation rules do not apply, such as a late allocation of GST exemption, the allocation is made on line 6 of Part 2 of Schedule D and must also be described in an attached Notice of Allocation. Line 7 must provide the total amount of GST exemption allocated, including the exemption allocated on the current year's return. By subtracting the amount on line 3 from the amount on line 7, the amount shown on line 8 provides the total amount of available exemption accounting for the exemption allocated on the current year's return.

1. Notice of Allocation

   If a taxpayer wants to allocate GST exemption to a transfer other than a direct skip, and the transfer does not qualify under the automatic allocation rules, the taxpayer is required to allocate the exemption on line 6 of Schedule D and attach a Notice of Allocation to the return. Such notice must clearly identify the trust, provide the EIN of the trust, indicate which item number(s) from Part 1 of Schedule A report the transfers to the trust, the value(s) of the gift(s) (it is important to note if the taxpayer and his or her spouse elect to gift-split, the amount of GST exemption allocated should take such election into account), the amount of GST exemption allocated to each transfer (formula allocations are permitted), and the inclusion ratio of the trust after the allocation.

2. Late Allocation of GST Exemption

   If the taxpayer wants to allocate GST exemption to a trust so that the trust's inclusion ratio is zero, and wants to make such allocation on a return that is not timely filed, the taxpayer must allocate an amount of GST exemption equal to the value of the property either on the date the return is filed or on the first day of the month in which that return is filed.[140] In 2001, the IRS issued Notice 2001-50,[141] which provided that taxpayers may seek an extension of time in which to affirmatively allocate GST exemption pursuant to Treas. Reg. § 301.9100-3. If relief is granted, the amount of GST exemption necessary to reduce the trust's inclusion ratio to zero is based on the value of the property as of the date of the gift. In order to obtain such relief, it was necessary for the taxpayer to request a private letter ruling.

[140] I.R.C. § 2642(b)(3).
[141] Notice 2001-50, 2001-2 C.B. 189.

3. Revenue Procedure 2004-46.

On August 2, 2004, the IRS issued Rev. Proc. 2004-46,[142] in order to provide taxpayers with a simplified alternative method for the late allocation of GST exemption. In order to be eligible for such relief, the taxpayer must satisfy the following requirements:

a. On or before December 31, 2000, the taxpayer made or was deemed to have made a transfer by gift to a trust from which a generation-skipping transfer could be made;

b. At the time the taxpayer files the request for relief under this Revenue Procedure, no taxable distributions have been made and no taxable terminations have occurred;

c. The transfer qualified for the annual exclusion, and the amount of the transfer, when added to the value of all other gifts by the transferor to that donee in the same year, was equal to or less than the amount of the applicable annual exclusion for the year of the transfer;

d. No GST exemption was allocated to the transfer, whether or not a return was filed;

e. At the time the taxpayer files a request for relief under the Revenue Procedure, the taxpayer has unused GST exemption available to allocate to the transfer; and

f. All the procedural requirements, as set forth in Rev. Proc. 2004-46, have been met.

g. The procedural requirements set forth in Rev. Proc. 2004-46 are as follows:

   File a return for the year of the transfer to the trust, regardless of whether a return was filed for such year. Write at the top of the return that the return is "FILED PURSUANT TO REV. PROC. 2004-46";

   Report the value of the transferred property on the date of the gift on the return; and

   Allocate GST exemption to the trust by attaching a Notice of Allocation containing a clear identification of the trust, as defined in § 6109 of the Code, including the trust's EIN, the value of the property transferred as of the date of the

[142] Rev. Proc. 2004-46, 2004-31 I.R.B. 142.

transfer (adjusted to account for split-gifts, if any), the amount of the taxpayer's unused GST exemption at the time the Notice of Allocation is filed, the amount of GST exemption allocated to the trust, the inclusion ratio of the trust after the allocation, and a statement that all of the requirements of section 3.01 of Rev. Proc. 2004-46 have been met.

If relief is granted under Rev. Proc. 2004-46, the taxpayer will be able to allocate GST exemption based on the value of the assets transferred to the trust, as of the date of the transfer. It is not necessary to apply for a private letter ruling pursuant to the Revenue Procedure.

iii. Part 3—Tax Computation

Every gift listed in Part 1 of Schedule D must be entered into Part 3. In column A, the taxpayer provides the item number from Part 1 of Schedule D. Column B requires the net transfer amount from Part 1 of Schedule D. Column C requires the GST exemption allocated to the gift. The total GST exemption allocated is totaled at the bottom of column C. To complete column D, the taxpayer divides column C by column B. The inclusion ratio, which is one less the amount in column D, is included in column E. The GST tax rate exists in column F. Column G requires the product of the tax rate times the inclusion ratio, providing the applicable rate to be applied for the generation-skipping transfer. To complete column H, the taxpayer multiplies the net transfer from column B by the applicable rate in column G, providing the GST tax on the gift listed in that line. The taxpayer provides the total of the GST tax applied to the gifts in Part 3 at the bottom of column H and also carries this amount over to line 10, Part 4 of Schedule A and on line 16 of the page 1 Tax Computation.

3. Section 2513—Gift-Splitting

Many practitioners assume that they have a complete understanding of gift-splitting. The reality is that the laws surrounding gift-splitting are very complex and an election to split gifts, or the failure to properly split gifts, could cause unintended adverse tax consequences. Estate planning practitioners should have a complete understanding of the requirements that must be met in order for a married couple to elect to split gifts, as well as the effects of such an election. For example, once an election to split gifts has been made, the taxpayers may not choose which gifts they will split as the election is applicable to all gifts made by each of them during the calendar year. Moreover, once made, the election is irrevocable.

The spouses must meet certain requirements to split gifts:[143]

- At the time of the gift, each spouse must be a U.S. citizen or a U.S. resident.

- At the time of the gift, the spouses must be married.

- If during the same year the gift was made, the spouses divorce, they may still elect to split gifts made while they were married, provided neither of them remarries during the same calendar year.

- Both the donor spouse and the non-donor spouse must signify their consent to the election to split gifts.

[143] I.R.C. § 2513(a).

If these requirements are satisfied, all gifts made by the married couple will be deemed to be made one-half by the donor and one-half by the donor's spouse (except for gifts to the donor's spouse).

a. Limitations as to Which Gifts a Couple May Elect to Split

There are certain limitations for spouses splitting gifts. A couple may not elect to split gifts to each other. A gift by the donor spouse cannot be split where the donor spouse grants the non-donor spouse a general power of appointment.[144] If a donor spouse transfers property so that a portion of the property interest is gifted to a third party and a portion of the interest is gifted to his or her spouse, in order for the interest transferred to the third party to be eligible for gift-splitting, such interest must be ascertainable at the time of the gift and hence severable from the interest transferred to the non-donor spouse. As there are some questions as to the meaning of an "ascertainable interest" that would qualify for gift-splitting, some of the cases below define "ascertainable" for gift-splitting purposes.

An election to split gifts may be made on behalf of a deceased donor by such donor's executor. However, the gift must have been made while the donor spouse was still living. An election to split gifts may also be made by an agent of the spouse.[145] An agent may not make the election unless, by reason of illness, absence, or non-residence, the person liable for the return is unable to make it within the time prescribed.[146] Furthermore, if by reason of illness, absence or non-residence, a return is made by an agent, the return must be ratified by the donor or other person liable for its filing within a reasonable time after such person becomes able to do so.[147]

b. Gift-Splitting Revenue Rulings, Cases and Private Letter Rulings

i. Revenue Ruling 73-207[148]

The donor spouse owned various life insurance policies on the life of her husband, the non-donor spouse. The couple's children were designated as the beneficiaries of the policies' death benefits. Following the death of the non-donor spouse, the donor spouse filed a return on which she reported the transfer of the death benefit proceeds to her children. The executor of the estate of the non-donor spouse signed the return to signify the consent of the non-donor spouse to split gifts and, thus, the gift was treated as being made one-half by the donor spouse and one-half by the non-donor spouse. The IRS noted that the regulations provide that consent to split gifts is not effective with respect to any gift made by the surviving spouse during the part of the year that the non-donor spouse is deceased.[149] The

[144] I.R.C. § 2513(a)(1).
[145] Treas. Reg. § 25.6019-1(h).
[146] *Id.*
[147] *Id.*
[148] Rev. Rul. 73-207, 1973-1 C.B. 409.
[149] Treas. Reg. § 25.2513-1(b)(1).

IRS held that the designation of the children as the beneficiaries of the policies was not a completed gift, as the beneficiaries could be changed at any time prior to the death of the non-donor spouse. Thus, the gift was made at the time of the non-donor spouse's death, which was also the exact time the marital relationship ceased to exist. Consequently, the gift was not eligible for gift-splitting.

ii. Revenue Ruling 78-27[150]

The donor spouse gifted real property to the child of the donor spouse and the non-donor spouse. The donor spouse went to the preparer's office to sign the return and, as a matter of convenience, forged the non-donor spouse's signature on the line where the non-donor spouse was required to consent to split gifts. One year later, the donor spouse filed an amended return. On such return, the non-donor spouse signed her own name to signify her consent to split gifts. The IRS held that the signature by the donor spouse of the non-donor spouse's name was not sufficient to signify consent to split gifts and that the filing of the amended return did not perfect such consent.

iii. *Kass v. Comm'r*[151]

Donor spouse made a gift in trust of corporate stock. The value of the stock as of the date of transfer was $54,000. The donor spouse and non-donor spouse each filed a return electing to split the gift of corporate stock to the trust. The trust provided that the net income of the trust should be paid to the non-donor spouse for life. The trustees of the trust, in their absolute discretion, could pay from the principal of the trust any sum they deemed necessary or advisable for the "general welfare" of any income beneficiary to such beneficiary.

The issue was whether the portion of the transfer of the stock to the trust attributable to third parties was ascertainable so that such transfer would be eligible for gift splitting. The Tax Court held that the interest transferred to the third parties was not ascertainable as it could not be shown that the non-donor spouse's other funds would make the invasion of the trust's principal for her benefit unlikely.

iv. *Wang v. Comm'r*[152]

Donor spouse was the grantor of a trust agreement. The trust agreement provided that during the joint lives of the donor spouse and the non-donor spouse, the trustees should distribute the trust income to the non-donor spouse. Upon the death of the donor spouse, if the non-donor spouse was

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[150] Rev. Rul. 78-27, 1978-1 C.B. 387.***
[151] *Kass v. Comm'r*, T.C. Memo 1957-227 (December 12, 1957).
[152] *Wang v. Comm'r*, T.C. Memo 1972-143 (June 29, 1972).

living, the trustees were to set apart a separate portion of the trust assets, to be referred to as "Fund A" to be administered for the non-donor spouse's benefit. Fund A was to consist of an amount equal to the difference between one-half of the value of the donor spouse's adjusted gross estate and the value of all the property passing to the non-donor spouse pursuant to the donor spouse's will or by operation of law. Only assets that would qualify for the marital deduction were to be used to fund Fund A. The balance of the trust was to be used to fund "Fund B." The non-donor spouse was to receive the income from Fund A during her lifetime and she had a noncumulative right to withdraw $10,000 per year from the principal of Fund A for any purpose whatsoever and in her sole discretion. The non-donor spouse also had a general power of appointment over Fund A. The trustees were also allowed to distribute as much of the trust's principal to the non-donor spouse as they deemed necessary or advisable for her proper care, support, and health or in the event of an emergency affecting the non-donor spouse. Upon the death of the non-donor spouse, the balance of the trust was to be divided equally into three trusts. Each then living child of the donor-spouse would be the beneficiary of one trust and if a child had predeceased the non-donor spouse, such child's share would be administered for the benefit of such deceased child's issue.

The donor spouse filed a return for 1963, reporting that property valued at $71,141.73 was transferred to the trust. The donor spouse reported $50,829.34 as attributable to the remainder interest transferred in trust for the benefit of third parties. Accordingly, the donor spouse and the non-donor spouse elected to split such gift and, thus, each reported a gift of $25,414.67. The IRS issued a notice of deficiency to the donor spouse claiming that the portion of the gift attributable to third parties was not ascertainable and, thus, not eligible for gift-splitting.

The issue was whether the gift of the remainder interest of property in trust by donor spouse should be considered as made one-half by such spouse and one-half by the non-donor spouse. Consent to split gifts is effective with respect to an interest transferred to third parties only insofar as such interest is ascertainable at the time the gift is made, and hence severable from the interest transferred to the spouse.[153] The Tax Court referred to the principles established in cases where it was necessary to determine whether a power given to a trustee to invade the principal of a trust for the benefit of a life tenant renders the bequest to a charity by way of a charitable remainder trust so indefinite as to render it impossible to ascertain the value of such bequest for the purposes of a charitable deduction. The court noted that such cases held that the answer depends on whether the trustee's power was limited by an ascertainable standard. The court noted that an ascertainable standard only exists when the

[153] Treas. Reg. § 25.2513-1(b)(4).

language of the document provides that the trustee is only permitted to invade the principal for health, education, support and maintenance.

The court held that the standard in the trust at issue was not an ascertainable standard, as the term "emergency" was not limited to preserving the spouse's present standard of living. Thus, the gifts of remainder interests were not permitted to be split.

v. Private Letter Ruling 200345038[154]

The donor spouse established three irrevocable trusts. The beneficiaries of trust 1 were the non-donor spouse and the donor spouse's daughter, the beneficiaries of trust 2 were the non-donor spouse and the donor spouse's son, and the beneficiaries of trust 3 were the non-donor spouse and the donor spouse's other son. The trusts had identical terms. The trustee was to pay to the beneficiaries as much of the trust's income and principal as the trustee deemed necessary or appropriate for the health, maintenance, education and support of the beneficiaries. Each child had a general power of appointment over the trust of which he or she was a beneficiary. The donor spouse transferred assets to such trusts and the donor spouse and the non-donor spouse filed returns to report such gifts, and elected to split gifts, but failed to allocate the proper amount of GST exemption. The taxpayers requested a private letter ruling requesting an extension of time to allocate their GST exemptions to such transfers. In the private letter ruling, the IRS discussed the issue of whether the transfer to the third parties was ascertainable and, thus, eligible for gift-splitting. The IRS concluded that because the trust provided that income and principal could be paid to the non-donor spouse for such spouse's health, maintenance, education and support, the interest transferred to the children was ascertainable and, thus, eligible for gift-splitting.

vi. Private Letter Ruling 200422051[155]

The donor spouse created an irrevocable trust to hold life insurance. The non-donor spouse had a non-cumulative right to withdraw an aggregate amount not to exceed a certain sum each year during the donor spouse's lifetime. Upon the death of the donor spouse, the non-donor spouse received all of the income for her life and as much principal as is required for her reasonable support and medical care. Upon the non-donor spouse's death, the donor spouse's children were to receive the remaining trust property. The IRS decided that the ascertainable standard of invasion for the non-donor spouse was susceptible of determination of the right of the non-donor spouse's right to receive trust property, meaning that the non-donor spouse's interest was severable from the other beneficiaries.

[154] PLR 200345038.
[155] PLR 200422051.

Consequently, the donor spouse and the non-donor spouse were eligible to split the donor's gifts to the insurance trust.

vii. Private Letter Ruling 200616022[156]

The donor spouse created an irrevocable trust. If, (i) the non-donor spouse survives the donor spouse, (ii) the death of the donor spouse occurs within three years of the donor's funding of the trust and (iii) all or a substantial portion of the trust assets are includable in the donor spouse's estate, the trust assets were to be held in a qualified terminable interest property trust with an ascertainable standard of invasion for the non-donor spouse. The IRS determined that the non-donor spouse's contingent interest in the trust was susceptible of determination and severable from the gifts to the other beneficiaries, thereby allowing the gifts to the trust to be split.

c. Manner and Time of Signifying Consent to Split Gifts

i. When Only One Spouse Files a Return

If gift-splitting is elected and only one spouse makes gifts during the calendar year, the other spouse is not required to file a return provided that the total value of the gifts made to each third party donee is not in excess of two times the annual exclusion amount and no portion of the property transferred constitutes a gift of a future interest. In such a case, the consent of both spouses should be signified on the donor spouse's return.[157]

ii. When Both Spouses File Returns

Consent may be signified in one of three ways: (1) the consent of the husband may be signified on the wife's return and vice-versa, (2) the consent of each spouse may be signified on his or her own return, or (3) the consent of both spouses may be signified on one of the returns.[158]

iii. Time for Consent

Consent may not be signified after April 15th of the year following the year in which the gift was made. However, if no return was filed by either spouse on or before April 15th, consent may be signified on a late-filed return. If one of the spouses filed on or before April 15th and consent was not signified, consent may not be signified on the second spouse's return when it is filed. If either spouse receives a notice of deficiency with

[156] PLR 200616022.
[157] Treas. Reg. § 25.2513-2(a)(1).
[158] Treas. Reg. § 25.2513-2(a)(1).

respect to gift tax for the year in which the gift was made, consent to split may not be signified for such period.[159]

iv. Time for Consent for Gifts Made after December 31, 1970 and before January 1, 1982

Consent must have been signified by the 15th day of the second month following the calendar quarter in which the gift was made if a return was filed by such time. If no return was filed, consent must have been signified on the return at the time of filing such return. Once a return was filed, consent could no longer be signified.[160]

v. Revocation of Consent

If consent was made on or before April 15th of the year following the year in which the gift was made, the consent may be revoked on or before April 15th of such year. The revocation may be made by either spouse filing in duplicate a signed statement of revocation. Such statement must be filed on or before April 15th of the year following the year in which the gift was made. If consent is signified after April 15th of the year following the year in which the gift was made, it may not be revoked.[161]

vi. Revocation of Consent for Gifts Made after December 31, 1970 and before January 1, 1982

If consent was made on or before the 15th day of the second month following the calendar quarter in which the gift was made, the consent to split must have been revoked on or before the 15th day of such month. If consent is signified after the 15th day of the second month following the quarter in which the gift was made, consent must have been signified on the return at the time such return was filed. If consent was signified after the 15th day of the second month following the quarter in which the gift was made, such consent may not be revoked.[162]

vii. Joint and Several Liability

When spouses elect to split gifts, the entire gift tax liability of each spouse for that tax year is joint and several.[163] Notwithstanding the joint and several liability, in CCA 200205027, the IRS held that although the gift tax liability was joint and several, fraud on the part of the donor spouse could not cause the statute of limitations to remain open with respect to the return filed by the non-donor spouse.

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[159] Treas. Reg. § 25.2513-2(b)(1).
[160] Treas. Reg. § 25.2513-2(b)(2); Rev. Rul. 80-224, 1980-2 C.B. 281.
[161] Treas. Reg. § 25.2513-3.
[162] Treas. Reg. § 25.2513-3.
[163] I.R.C. § 2513(d); Treas. Reg. § 25.2513-4.

viii. No Deemed Gift for Payment of Entire Gift Tax Liability by One Spouse

If a husband and wife elect to split gifts and the gift tax liability with respect to such transfers is paid by one spouse, the payment of the tax is not deemed a transfer subject to gift tax.[164] This is consistent with the provisions of Section 2523 of the Code which applies the unlimited marital deduction to transfers between spouses during life.

d. Allocation of GST Exemption

If an election to split gifts is made to treat the gift as made one-half by the donor spouse and one-half by the non-donor spouse, such gift is also treated as if made one-half by each spouse for purposes of the GST tax.[165] For example, if A transfers real property to a trust for the benefit of his grandchild and A and his wife, B, each file a return which signifies their consent to split all gifts made during the calendar year, each spouse should also allocate GST exemption to the transfer in an amount equal to one-half of the value of the gift.

i. Private Letter Ruling 200422051 and Section 26.2652-1(a)(4) of the GST Tax Regulations

It should be noted that if A transferred property to a trust for the benefit of his wife, B, during her life and for the benefit of a third party following her death, and A and B want to elect to split the gift of the remainder interest (assuming it was ascertainable and severable from the wife's interest in the trust), each spouse would allocate GST exemption in an amount equal to one-half of the value of the property transferred to the trust. Although the spouses may not split the gift attributable to the interest transferred to the non-donor spouse, the non-donor spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor, regardless of the interest the non-donor spouse is actually deemed to have transferred.[166]

ii. Technical Advice Memorandum 200147021[167]

Husband and wife each made gifts to their grandchildren during the calendar year. At the time of the gift, husband had utilized all of his gift tax exemption and GST exemption. Thus, the direct skips were subject to GST tax. Husband and wife elected to split gifts. An additional gift resulted because the GST tax imposed on the transferor attributable to a direct skip is considered an additional gift to the donee.[168] The spouses also split the additional gift on their respective returns and the IRS agreed that such treatment was required.

[164] Treas. Reg. § 25.2511-1(d).
[165] I.R.C. § 2513.
[166] Treas. Reg. § 26.2652-1(a)(4); PLR 200422051.
[167] TAM 200147021.
[168] I.R.C. § 2515.

iii. GST Exemption Allocation when Split-Gift Subject to an ETIP

If a gift is made subject to an ETIP and such gift is split by the donor spouse and non-donor spouse, no allocation of GST exemption is made at the time the gift is reported. The GST exemption will be allocated at the close of the ETIP. If the non-donor spouse dies prior to the close of the ETIP, such spouse's executor may allocate GST exemption to such transfer up to the amount of which the non-donor spouse is treated as the transferor. The allocation will not be effective until the close of the ETIP.[169]

e. Uniform Transfers to Minors Act

i. Section 2038

The gross estate of a decedent includes the value of all property transferred by the decedent, in trust or otherwise, over which he or she holds, at the date of his or her death, either alone or in conjunction with any other person, the power to alter, amend, revoke or terminate the enjoyment of the beneficial interest.[170]

ii. Revenue Ruling 59-357

In this Revenue Ruling, the IRS held that the value of any transfer of property to a minor under the Uniform Gifts to Minors Act is includible in the gross estate of the donor for federal estate tax purposes if the donor appoints himself or herself custodian and dies while serving as such custodian.[171]

iii. Revenue Ruling 74-556[172]

The donor spouse transferred securities owned by him, individually, to himself as custodian for his minor daughter under the Uniform Gifts to Minors Act. After filing the return on which the spouses elected to split gifts, the donor spouse became incapacitated and the non-donor spouse was appointed as successor custodian.[173] The non-donor spouse died while serving in such capacity. The issue was whether one-half of the value of the securities should be included in the estate of the non-donor spouse on the basis that she transferred such securities by signifying her consent to split gifts and she held the securities as custodian upon her death. In order for an asset to be included in the estate of a decedent, the decedent must "transfer" such asset prior to his or her death.[174] A spouse

[169] Treas. Reg. § 26.2632-1(c)(5), Example 3.
[170] I.R.C. § 2038.
[171] Rev. Rul. 59-357, 1959-2 C.B. 212.
[172] Rev. Rul. 74-556, 1974 C.B. 300.
[173] I.R.C. § 2513.
[174] I.R.C. §§ 2035 & 2038.

who elects to split gifts is not deemed to have actually transferred the gifts of the donor spouse; therefore, the IRS held that no part of the value of the assets transferred by the donor spouse would be included in the estate of the non-donor spouse upon her death.

f. Section 2001(e)—Coordination of Sections 2513 and 2035

i. Section 2035

If, (1) a decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the three-year period ending on the date of the decedent's death and (2) the value of such property (or any interest therein) would have been included in the decedent's gross estate under §§ 2036, 2037, 2038 or 2042 of the Code if such transferred interest or relinquished power had been retained by the decedent on the date of his or her death, the value of the gross estate includes the value of any property (or interest therein) which would have been so included (the "three-year rule").[175] The amount of any gift tax paid by the decedent or the decedent's estate on any gift made by the decedent or the decedent's spouse during the three-year period ending on the date of decedent's death is also included in the decedent's gross estate.[176]

ii. Revenue Ruling 81-85[177]

Donor spouse made a gift to his child and the non-donor spouse elected to split gifts. The gift tax attributable to the transfer was paid entirely from the donor spouse's assets. Soon thereafter, the non-donor spouse died. No part of the gift was included in her gross estate, but one-half of the gift was included in the estate calculation as an adjusted taxable gift. Such amount was reduced by the gift tax attributable to one-half of the gift. Upon the death of the donor spouse, which was within three years of the date of the gift, the total amount of the gift, including the one-half treated as having been made by the donor spouse, and the total gift taxes thereon, were includible in the donor spouse's estate. The estate of the non-donor spouse filed a claim for refund claiming that the estate tax should be recomputed due to the fact that such tax was absorbed by the estate of the donor spouse. The IRS held that when a donor spouse dies after the death of the non-donor spouse and a gift that the non-donor spouse consented to split was includible in the donor spouse's estate pursuant to the three-year rule, the estate of the non-donor spouse is entitled to re-compute its tax.[178] Accordingly, one-half of the gift should not be included in the adjustable

[175] I.R.C. § 2035.
[176] I.R.C. § 2035(b).
[177] Rev. Rul. 81-85, 1981-1 C.B. 452.
[178] I.R.C. § 2001(e).

taxable gifts of the non-donor spouse and the tentative tax should not be reduced by any amount of gift tax payable on the split gift.

iii. Revenue Ruling 82-198[179]

Donor spouse transferred property to an irrevocable trust under which the income was payable to the donor spouse for life and, upon the death of the donor spouse, the remainder would pass to a third party. The donor spouse and the non-donor spouse each filed a return and elected to split gifts. Upon the death of the donor spouse, which was within three years of the date of the gift, the value of the assets gifted to the irrevocable trust were included in the donor spouse's estate.[180] The IRS held that upon the death of the non-donor spouse, which was also within three years of the date of the gift, no portion of the gift would constitute an adjustable taxable gift in the estate of the non-donor spouse where the full amount of the gift is included in the gross estate of the donor spouse.[181] The IRS further held that the estate of the non-donor spouse would receive no credit under § 2001(b)(2) of the Code for the gift tax paid by such spouse and any gift tax paid by the non-donor spouse is included in that spouse's gross estate pursuant to the three-year rule.[182]

iv. Transfers to QPRTs/GRATs/GRITs

In general, gift-splitting should not be elected when one spouse gifts assets to a QPRT, GRAT or GRIT. If the donor spouse dies during the term of the trust, the entire value of the assets gifted will be included in the gross estate of the donor spouse and the non-donor spouse will receive no credit for such inclusion upon his or her death. The result is that the gift tax exemption of the non-donor spouse could be wasted. In the case of a gift to a "zeroed out" GRAT, it should not make a difference whether gift-splitting is elected.

[179] Rev. Rul. 82-198, 1982-2 C.B. 206.
[180] I.R.C. § 2035.
[181] I.R.C. § 2035.
[182] I.R.C. § 2035(c).

EXHIBIT B

ADEQUATE DISCLOSURE CHECKLIST FOR TRANSFER TAX RETURN[183]

Client:____

Appraiser:____

Asset Transferred:____

Date of Gift:____

Date of Appraisal: ____

ADEQUATE DISCLOSURE, GENERALLY

If a gift or bequest (defined as "transfer" for purposes of this set of checklists) is not adequately disclosed for the calendar year period in which the transfer occurred. Consequently, the statute of limitations is not tolled on the transfer, and the Internal Revenue Service is free to audit the transfer at any time, which could result in additional tax and interest, potential penalties, and even additional tax on later transfers, given that the gift tax computation takes into account earlier gifts.

On the other hand, if adequate disclosure occurs, the statute of limitations will run its course, and the nature of the transfer and the basis for the value reported may not be examined by the Service after the statute's expiration. This general rule is applicable to transfers made after August 5, 1997. For gifts made prior to that date, the Service was barred from revaluation related to any transfer in a year in which a gift tax return was filed, gift tax was paid or assessed, and the statute of limitations had run.

[183] Original format created by Tom Overbey, ACTEC Fellow; toverbey@artaxlaw.com.

<table>
<tr><th colspan="2">Adequate Disclosure Requirements</th><th>Support</th><th>Y/N</th><th>Authority</th></tr>
<tr><td colspan="2">1. Description of transferred property and any consideration received by transferor</td><td></td><td></td><td>Treas. Reg. § 301.6501(c)-1(f)(2)(i)</td></tr>
<tr><td colspan="2">2. Identity of, and relationship between, transferor and transferee(s)</td><td></td><td></td><td>Treas. Reg. § 301.6501(c)-1(f)(2)(ii)</td></tr>
<tr><td colspan="2">3. If property is transferred in trust, trust's tax identification number and either: (a) brief description of terms governing trust, or (b) copy of trust instrument</td><td></td><td></td><td>Treas. Reg. § 301.6501(c)-1(f)(2)(iii)</td></tr>
<tr><td colspan="2">4. Either of:</td><td rowspan="2"></td><td rowspan="2"></td><td rowspan="2">Treas. Reg. § 301.6501(c)-1(f)(2)(iv)</td></tr>
<tr><td>(a) Appraisal meeting these requirements:

(i) Is prepared and signed by individual who:

(1) holds himself out to public as appraiser or regularly performs appraisals;

(2) is qualified to make appraisals of type of property being valued, based on qualifications described in appraisal; and

(3) is someone other than donor, donee, member of family of donor or donee, or employee of donor, donee, or member of family of donor or</td><td>(b) Detailed description meeting these requirements:

(i) Includes:

(1) financial data (e.g., balance sheets with explanations of adjustments) utilized in determining value,

(2) restrictions on transferred property considered in determining fair market value, and

(3) description of adjustments claimed in valuing transferred property (e.g., discounts for blockage, minority or fractional interests, and lack of marketability).

(ii) If transferred property is interest in actively traded entity on established</td></tr>
</table>

Adequate Disclosure Requirements		Support	Y/N	Authority
donee. (ii) Provides: (1) date of transfer, date of appraisal, and purpose of appraisal; (2) description of transferred property; (3) description of appraisal process; (4) description of assumptions, conditions, and restrictions affecting appraisal; (5) all information considered in determining appraised value; (6) procedures followed and underlying reasoning; (7) valuation method used, rationale for method, and procedure used in determining fair market value of transferred property; and (8) specific basis for valuation.	exchange, includes: (1) recitation of exchange where interest is listed, (2) CUSIP number of security, and (3) mean between highest and lowest quoted selling prices on valuation date. (iii) If transferred property is interest in entity not actively traded, includes: (1) discounts claimed in valuing interests in entity or assets owned by entity, (2) net asset value of entity, (3) pro rata portion of entity transferred, and (4) fair market value of interest transferred as reported on return.* (iv) If entity in which interest was transferred is not actively traded and owns interest in non-actively traded entity, provides information required in (ii) above for second entity if information is relevant and material in determining value of first entity			
5. Statement describing any position taken contrary to proposed, temporary, or final Treasury Regulations or revenue rulings published at time of transfer				Treas. Reg. § 301.6501(c)-1(f)(2)(v)

* This statement may be omitted if the fair market value of the entity is properly determined without regard to net asset value. However, the Regulations place the burden on the taxpayer for demonstrating that the value is properly determined by some other method.

Pursuant to Treas. Reg. § 1.1704-13(c)(5)(iv), the following persons cannot be qualified appraisers:

1. Donor or taxpayer reporting sale on income tax return; member of family of donor or donee or selling taxpayer;
2. Party to transaction in which donor or seller acquired subject property, unless property is transferred within two months of acquisition and appraised value does not exceed acquisition price;
3. Person(s) or business entities receiving or purchasing subject property;
4. Employee of person or organization listed above;
5. Person related to, or married to person related to, person or organization listed in I.R.C. § 267(b); or
6. Appraiser regularly used by excluded person described in categories 1-3 above and who does not perform majority of appraisals made during taxable year for other persons.

GIFTS OF INTERESTS IN CORPORATIONS, PARTNERSHIPS, AND TRUSTS ONLY

Gifts[184] of interests in a corporation, partnership, or trust on or after January 28, 1992 (*i.e.*, gifts subject to the special valuation rules of I.R.C. §§ 2701, 2702) or the occurrence of a subsequent taxable event due to a failure to make timely payments of qualified payments under § 2701 (*i.e.*, taxable events described in Treas. Reg. § 25.2701-4) must provide the information below, in addition to that listed above, in order to adequately disclose the transfer. Note that the entire transaction or series of transactions (including any transaction affecting the transferred interest) of which the gift was a part should be disclosed. *See* Treas. Reg. § 301.6501(c)-1(e)(2).

Adequate Disclosure Requirements Specific to Transfers of Interests in Corporations, Partnerships, Trusts	Support	Y/N	Authority
1. Description of transaction, including description of transferred and retained interests and method(s) used to value each			Treas. Reg. § 301.6501(c)-1(e)(2)(i)
2. Identity of, and relationship among: (a) transferor, (b) transferee, (c) all persons participating in transaction, and (d) all parties related to transferor holding equity interest in any entity involved in transactions			Treas. Reg. § 301.6501(c)-1(e)(2)(ii)
3. Detailed description, including actuarial factors and discount rates used, of method used to determine amount of gift arising from transfer or taxable event			Treas. Reg. § 301.6501(c)-1(e)(2)(iii)
4. If transfer is of entity interest not actively traded, detailed description of financial and other data used in determining value, generally including: (a) balance sheets, (b) statements of net earnings, (c) operating results, and (d) dividends paid for each of 5 years immediately before valuation date			Treas. Reg. § 301.6501(c)-1(e)(2)(iii)

[184] Note that these provisions, by their terms, only apply to Chapter 11 (gifts), not Chapter 12 (bequests).

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EXHIBIT C

INTERNAL REVENUE SERVICE'S TYPICAL INFORMAL DISCOVERY REQUEST QUESTIONS

LLC/PARTNERSHIP FORMATION ATTORNEY/CPA INTERVIEW QUESTIONS

INDIVIDUALS PRESENT:

____________________________________, Estate Tax Attorney;
____
____
____

Questions were asked by Estate Tax Attorney and answers were given by _____________ unless otherwise specified.

All references to "LLC/Partnership" are to the _____________________________

All references to Donor/Decedent are to __________________________________

A. Please do not speculate as to any answer; provide answers only if you have personal knowledge of the answer.

   1. Is there any medical or other reason that would affect your ability to understand and answer questions today?

   2. When did you become the Donor/Decedent's attorney?

   3. What work have you performed for the Donor/Decedent in general in the past?

   4. How did the Donor/Decedent become your client for purposes of forming the LLC/Partnership?

   5. What file(s) do you maintain on the LLC/Partnership or the Donor/Decedent's estate planning?

   6. Describe each document in your files on the LLC/Partnership.

B. The following questions pertain to the time period beginning when you had first contact with the Donor/Decedent or anyone on the Donor/Decedent's behalf in connection with the decision to form the LLC/Partnership and ending with the execution of the LLC/Partnership operating agreement.

   1. Who was involved in the decision to form the LLC/Partnership?

   2. Indicate approximately how many meetings were held during the decision making process.

3. What were the dates, locations, and approximate duration of each of these meetings?

4. Who attended each meeting?

5. Did you take any notes at these meetings?

6. What documents did you hand out at the meetings?

7. Were there any discussions over the telephone about the formation?

8. How many telephone conversations did you have during the decision making process?

9. With whom did you talk during these telephone conversations?

10. Did you take any notes of the telephone calls?

11. Approximately how many emails, letters or other correspondence did you send and receive?

12. Did you prepare or have the Donor/Decedent, or anyone on his/her behalf, complete questionnaires about the Donor/Decedent's estate planning desires?

13. Who exactly was your client for purposes of forming the LLC/Partnership?

14. Was each member represented by her own counsel?

15. Did you prepare any fee, retainer or similar agreements?

16. Did you prepare any waiver of conflict of interest or similar document for the members retaining you jointly?

17. Did you issue billing statements describing the services you rendered?

18. Is every meeting and telephone conversation described in your bills?

19. Do you maintain any documents describing the services you have rendered other than the bills you have issued, such as pre-bills or other summaries of services rendered?

20. Did you prepare any computations of tax savings for the meetings with the Donor/Decedent or his family?

21. Did you discuss the tax benefits to be derived from the formation of the LLC/Partnership with the Donor/Decedent?

22. Were any flow charts, graphs or similar documents presented to the Donor/Decedent?

23. What reasons did the Donor/Decedent give you for the formation of the LLC/Partnership?

24. Who was present when the Donor/Decedent gave you the reasons for forming the LLC/Partnership?

25. Who else would have personal knowledge of the Donor/Decedent's reasons and motivations for forming the LLC/Partnership?

26. Do you know of any document (*e.g.*, letters, notes of meetings, etc.) that exists which may corroborate the Donor/Decedent's reasons and motivations for forming the LLC/Partnership?

27. Follow-up questions on reasons Donor/Decedent gave for formation of LLC/Partnership?