BUSINESS SUCCESSION PLANNING

R. Glenn Davis
ScottHulse PC

201 North Church Street, Suite 201
Las Cruces, New Mexico 88001
575.522.0765 (Office)
575.522.0006 (Facsimile)

201 East Main Drive, 11th Floor
El Paso, Texas 79901
915.546.8253 (Direct)
915.533.2493 (Firm)
915.546.8333 (Facsimile)

gdav@scotthulse.com

COMMUNITY FOUNDATION OF SOUTHERN NEW MEXICO
19TH ANNUAL ESTATE PLANNING INSTITUTE
November 3-4, 2011
Las Cruces, New Mexico

ScottHulse PC
ATTORNEYS AT LAW

R. GLENN DAVIS
Shareholder
Board Certified in Estate Planning and Probate Law,
Texas Board of Legal Specialization
Licensed in Texas and New Mexico

LEGAL EXPERIENCE

***ScottHulse PC*, El Paso, Texas**.
Shareholder – January 2001 to present; Associate – September 1995 to December 2000.

Practice includes estate planning, asset protection, probate and contested estates. Experience includes eleven years of trial practice in employment, commercial and general litigation. Licensed in Texas and New Mexico and admitted to the federal courts in the Western District of Texas, the District of New Mexico and the United States Court of Appeals for the Fifth Circuit.

***United States District Court for the Western District of Texas,* El Paso, Texas.**
Law Clerk for Chief Judge Harry Lee Hudspeth – August 1994 to August 1995.

***Supreme Court of the State of Texas,* Austin, Texas.**
Intern for Justice Lloyd Doggett – January 1994 to May 1994.

ARTICLES AND SPEECHES

- Scheduled Author and Speaker: 19th Annual Estate Planning Institute. Community Foundation of Southern New Mexico. *Business Succession Planning: How to do it Right*, November 3-4, 2011, Las Cruces, New Mexico.
- Author and Speaker: 2011 Southwest Regional Conference. American Society of Women Accountants. *Estate and Trust Accounting Under the Uniform Probate and Trust Codes*, May 20, 2011, Las Cruces, New Mexico.
- Author and Speaker: 2011 Tax Considerations in Estate Planning Course. State Bar of New Mexico. *The Federal Estate Tax – A Primer*, April 27-28, 2011, Albuquerque, New Mexico.
- Course Director and Speaker: 2nd, 3rd and 4th Annual New Mexico State University Estate Planning Conference for Women, 2009, 2010 and 2011, Las Cruces, New Mexico.
- Speaker: 2011 UTEP Estate Planning Conference for Women. *Legal and Practical Aspects of Estate Planning*, January 27, 2011, El Paso, Texas.
- Speaker: UTEP Women's Estate Planning Conference Reunion. *Estate Planning Uncertainty: Planning in the Shadows of 2010 & 2011*, December 9, 2010, El Paso, Texas.
- Author: "Key Points as EGTRRA's Sunset Looms", Texas Lawyer, Vol. 26, No. 34 (November 22, 2010).
- Author and Speaker: 18th Annual Estate Planning Institute. Community Foundation of Southern New Mexico. *Planning in Uncertain Times: Bypass (or Credit Shelter) and Marital Deduction Trusts in 2011 and Beyond*, November 4-5, 2010, Las Cruces, New Mexico.
- Author and Speaker: 2010 Advanced Estate Planning and Probate Course. State Bar of Texas. *International Issues in Estate Administration*, June 22-24, 2010, San Antonio, Texas.
- Speaker: El Paso Chapter, Texas Society of CPAs. *Estate Planning for 2010 & Beyond, or Be Careful of What You Wish for*, April 27, 2010, El Paso, Texas.

- Author and Speaker: 2009 Advanced Drafting: Estate Planning & Probate Course. State Bar of Texas. *Drafting for Non-Citizens and Non-Residents*, October 29-30, 2009, Dallas, Texas.
- Author and Speaker: 16th Annual Estate Planning Institute. Community Foundation of Southern New Mexico. *Planning with Irrevocable Life Insurance Trusts*, November 6-7, 2008, Las Cruces, New Mexico.
- Author and Speaker: 19th Annual Advanced Drafting: Estate Planning and Probate Course. State Bar of Texas. *Drafting for the Settlement of Estates and Trusts*, October 30-31, 2008, Austin, Texas.
- Speaker: 2008 NMSU Estate Planning Conference for Women. *Legal and Practical Aspects of Estate Planning*, January 23, 2008.
- Author and Speaker: 15th Annual Estate Planning Institute. Community Foundation of Southern New Mexico. *Advanced Planning Techniques with Incapacity in Mind*, November 1-2, 2007, Las Cruces, New Mexico.

EDUCATION

***University of Texas School of Law*, J.D.** with honors, Order of the Coif – May 1994.

***Texas A & M University*, B.A.** Economics, *magna cum laude* – May 1990.

AWARDS AND CIVIC AND RELIGIOUS INVOLVEMENT

- *State Bar of New Mexico, Real Property, Trust and Estate Section Board of Directors.* Budget Officer – 2011, Member - 2011 to present.
- *Southern New Mexico Estate Planning Council.* President – 2011 to 2012, 1st Vice-President – 2010 to 2011, Member 2006 to present.
- *Rio Grande Professional Advisor of the Year.* Community Foundation of Southern New Mexico. April 2009.
- *20th Annual Advanced Drafting: Estate Planning and Probate Course Planning Committee*. State Bar of Texas. Member - 2009.
- *17th, 18th & 19th Annual Estate Planning Institute Planning Committees*. Community Foundation of Southern New Mexico. Member – 2009, 2010 & 2011.
- *Leadership El Paso Class XXIX*, The Greater El Paso Chamber of Commerce, El Paso, Texas. Participant - 2007.
- *Insights El Paso Science Museum,* El Paso, Texas. Board Member – July 2006 to May 2008; Vice President – June 2004 to June 2006; Board Member – June 2002 to June 2004.
- *Beth El Bible Evangelical Free Church,* El Paso, Texas. Elder – December 2001 to May 2008; Member – 1995 to present.

FAMILY

Married to Laura Davis with five daughters: Emma, Audrey, Camille, Julia and Charlotte.

TABLE OF CONTENTS

I. INTRODUCTION 1
- A. An Anecdote of Failure 1
- B. The Problem 1
- C. Scope of Paper 2

II. EVALUATING THE CLIENT AND POTENTIAL SUCCESSORS 2
- A. The Client 2
- B. Fair Does Not Mean Equal 3

III. BUY-SELL AGREEMENTS 3
- A. Basic Types of Agreements 3
- B. The Relevant Parties 4
- C. Code Section 2703 Valuation Issues 4
- D. Likely Objectives 4
- E. Triggering Events 5
- F. Valuation Issues 5
- G. Funding Issues 5
- H. Ownership Structure Issues 6
- I. Issues with Third Parties 6

IV. LIMITED LIABILITY COMPANIES (AND LIMITED PARTNERSHIPS) 6
- A. Significant (?) Difference between LLCs and LPs 6
- B. Capitalization Flexibility 7
- C. Valuation Discounts 7
- D. Tiered Entities and Multi-Level Discounts 9

V. ESTATE FREEZE TECHNIQUES 9
- A. General Concept 9
- B. Sales to Intentionally Defective Grantor Trusts 9
  - 1. Background 9
  - 2. Component Parts of a Sale to an IDGT 11
  - 3. Grantor Trusts 11
  - 4. Appraisals 14
  - 5. The Promissory Note 14
  - 6. Reporting Concerns 14
  - 7. Defined Value Clauses 15
- C. Sales to Beneficiary Grantor Trusts 16
- D. Grantor Retained Annuity Trusts 17
  - 1. Applicable Interest Rate 17
  - 2. GRAT Requirements 17
  - 3. Survival Requirement 18
  - 4. GSTT Consequences 18
  - 5. Significant Options 18

E. Preferred Partnerships 18
F. Comparison of Various Estate Freeze Techniques 18

VI. SHIFTING FUTURE OPPORTUNITIES 19

VII. TRANSFERS AT DEATH 19
A. Surviving Spouses 19
1. Basic Estate Plan 19
2. The Portability Fallacy 20
3. Reverse QTIP Election 20
4. Marital Property Agreement 20
B. Descendants 21
1. Generation-Skipping Trusts 21
2. Spendthrift Trusts 21

VIII. APPRAISALS 21
A. Appraiser and Appraisal Standards 21
1. Appraiser Standards 21
2. Appraisal Standards 22

BUSINESS SUCCESSION PLANNING

I. INTRODUCTION

A. An Anecdote of Failure

In the early 1990's, Mr. and Mrs. X were nearing the end of their life and wanted to pass their substantial legacy to their children. At the advice of their CPA, they visited a well respected estate planning attorney and completed what they thought was a fair and effective plan for their estates.

Mr. and Mrs. X had started their farm right after World War II and built it practically from scratch. In the meantime, they started a family, raising one son and two daughters. The daughters married and began their own families, albeit far from Las Cruces. The son, however, stayed at home and worked with his father as soon as he was physically able. Together, the father and son built the farming business far beyond what the father could have done alone. Still, the parents owned all the land.

Like most parents, Mr. and Mrs. X loved all three of their children and wanted to treat them fairly. To them, "fairly" meant equally. But they also wanted to make sure that their son would be able to continue farming the land. Unfortunately, their wealth was inextricably intertwined with the farm and it did not make sense to break it up. In any event, the daughters had no interest in farming.

Mr. and Mrs. X recognized their family was not perfect. For some reason, the son did not like the daughters and the daughters did not like the son. The parents therefore did not rely upon the daughters' collective good will to allow the son to continue farming the land. Instead, they formed a limited liability company ("LLC") to hold the farmland.

The LLC had a fairly typical operating agreement. Among other things, the agreement required unanimous consent to sell a major asset of the company. This way, neither of the sisters could force the sale of the land if the son wanted to continue farming it. (Had the land been distributed outright to the children, any one of them could have brought a partition suit to force at least a division of the farmland.) Otherwise, majority vote controlled other decisions.

Apparently, Mr. and Mrs. X did not think through all the possibilities. Because all three children inherited equal shares of the Company, no one child controlled it. But no one anticipated that the sisters might vote together and essentially control the brother on all issues save one: whether the farm could be sold.

In the end, Mr. & Mrs. X's plan failed. The son, who depended on the farm for his livelihood found himself at the mercy of his sisters. The relationship between the siblings was forever ruined. The son felt deprived of what he saw as the rightful fruit of his labor growing up and as an adult, because he was forced to share it with his sisters. He also found himself with no real control over the farm that he helped build because his sisters ended up making all the decisions. The plan simply failed.

B. The Problem

Regularly, the media reminds us that the small businesses of this country are the backbone of its economic strength. Small businesses employ the majority of American workers and are responsible for approximately one-half of the gross domestic product and one-half of wages. Bowman-Upton, Nancy, *Transferring Management in the Family-Owned Business*, U.S. Small Business Administration, Emerging Business Series EB-1 (1991). Most small businesses also are family owned. Those that are not controlled by a single family are at least closely held among a handful of owners, each of whom typically has a family to consider.

As long as the founding entrepreneur is still running the business, the company's survival depends on the typical factors that face any business. But if the founder or one of the founders leaves the company (be it because of death, disability or retirement), the likelihood of survival plummets. According to the U.S. Small Business Administration, less than one-third of family-owned businesses survive the transfer of ownership from the first to the second generation. Bowman-Upton, *Transferring Management in the Family-Owned Business*. Let than one-half survive the transition to the third generation. *Id*.

Certainly, many different types of factors contribute to the dismal success rate of family businesses in the context of the death of an owner. The author is unaware of any empirical research supporting his belief, but common sense leads to the conclusion that poor planning for the transfer of ownership is at least a very significant hurdle for a small business to clear.

The "Death Taxes" imposed by the federal government also likely contribute to the high failure rate of small business upon the death of the owner.[1] While small businesses might have a high value, they

[1] As an aside, the author recently found himself not too surprised to learn upon reading the Communist Manifesto for the first time that Marx and Engels considered the abolition of all right of inheritance to be one of the measures that "are unavoidable as a means of entirely revolutionizing the mode of production" leading to the ideal state. Marx, Karl and Friedrich Engels, The Communist Manifesto, 104 (Penguin Classics Edition 1967). Other means include the abolition of property in land, a heavy progressive or graduated income tax, and the centralization of credit in the hands of the state. *Id*.

tend to be somewhat illiquid. Also, most small businesses tend to rely too heavily on the expertise and connections of the founder. The small business might have significant worth immediately before the founder's death, but lose that worth the very next day when the founder is gone. As a result, the taxation of the founder's estate can cause a fire sale to become necessary.

Proper planning for the succession of the business can lessen the sting of death. Hopefully, that planning can actually increase the chances for a successful transition to the next generation.

C. Scope of Paper

The goal of this paper is to introduce the reader, from a legal perspective, to the various issues about which any small business should be aware and for which it should implement a plan or plans to address. The paper also will discuss the various tools that are available to provide an efficient legal structure for the transition that will inevitably take place. It will concentrate on methods for keeping the business in the family and minimizing transfer taxes.

The paper will assume the reader has a basic understanding of the structure of estate taxes in the U.S. and the design of a basic tax planned estate. For a detailed discussion of theses matters, the author refers the reader to his papers entitled "The Federal Estate Tax – A Primer" and "Planning in Uncertain Times: Bypass (or Credit Shelter) and Marital Deduction Trusts in 2011 and Beyond", both of which are available upon request or at the website of the author's law firm, www.scotthulse.com.

The author does not intend to provide an exhaustive discussion of the various legal techniques available. Each technique, standing alone, warrants its own separate paper and the reader is encouraged to conduct independent research before embarking on the implementation of any technique suggested herein.

Because this paper is being presented at an estate planning conference located in New Mexico, it discusses state law aspects based on New Mexico law, which is a community property state. Many of the principles of New Mexico law can be generally applied to business succession planning in other states. Readers are cautioned, however, that state law governing business entities and trusts varies from state to state, sometimes rather significantly. Fortunately, the federal law principles discussed apply across the United States.[2]

Note that Title 26 of the United State Code (the portion that contains the IRS Tax Code) will be referred to as the "Code" throughout the paper. Similarly, the Treasury Regulations relating to the Code will be referred to as the "Regs.". The New Mexico statutes will be referred to as "NMSA".

II. EVALUATING THE CLIENT AND POTENTIAL SUCCESSORS

There will be little chance for a successful business succession without an analysis of the client's circumstances. Many issues come into play and the list is endless. Any planner should realize that no one profession has a monopoly on the process. Certainly, the client's attorney, certified public accountant, financial planner, and life insurance broker should play a part in the planning process.

A. The Client

The driving force behind any business succession plan is the client and his or her goals, fears and idiosyncrasies. The typical client who has built wealth through entrepreneurship tends to like control and power. Business succession plans, however, tend to require such a client to give up that control and consequent power. Other clients are ready to allow the next generation to take over, but are keenly interested in preserving a sufficient amount of cash flow to maintain the lifestyle to which they have become accustomed. How that cash flow is generated is of secondary concern to the latter type of client.

The advisor must help the client to evaluate his or her goals with respect to the client's own life and lifestyle, as well as for the future of the business and the next generation, all from a realistic and objective perspective. If the client has an unspoken plan of selling to the first bidder, regardless of what that sale might mean to children who may be employed in the family business, a well thought out business succession plan might be a waste of effort.

Also important is a realistic evaluation of the business's future potential. While the evaluation certainly is beyond the expertise of most attorneys (including the author), the advisor still should raise several issues. For example, the client should seriously consider the business's industry, competitiveness, reliance on and investment in technology and innovation, the age and maintenance of capital assets like buildings and equipment, subjection to price volatility, good will (and whether it is really associated with the business or the client), long term liabilities, potential changes in law and regulations affecting the

---

[2] Because the federal court system is based on eleven separate circuit courts of appeals and, in the context of certain federal tax disputes, the Tax Court, case law interpreting the finer points of federal tax law may differ from circuit to circuit. New Mexico is located in the Tenth Circuit, while Texas, for example, is located in the Fifth Circuit. The scope of this paper, however, does not reach the depths of such case law.

business, reliance on a small group of suppliers or customers and the company's work force. Perhaps the single most important evaluation will be of the second generation. If the second generation lacks the necessary experience or the necessary work ethic, is not competent or simply lacks interest, the plan likely will fail (if it involves transferring ownership to them). Perhaps the first step in any business succession plan is to begin training the second generation to take over the reigns.

B. Fair Does Not Mean Equal

Many parents apparently believe they have an obligation to treat each child equally.[3] As such, they want to give their children an equal share in the family business, ranch or farm, despite that only one of them might be actively involved. In the best of worlds, such an arrangement certainly could work. As owners, the siblings will pay the brother or sister who works in the business fair and adequate compensation commensurate with the time, effort and success the employee/owner gives towards the overall success of the company. Similarly, the employee/sibling will view himself or herself as working for all the owners. In essence, the company should operate like any other entity with passive investors.

There is a significant difference, though, between the family inherited business and non-family owned businesses. The owners, except for the one who has invested his or her life in the company, have invested nothing. Because human nature is what it is, resentment certainly will creep in, despite the effort and good faith of the sibling who is working. In a worse case scenario, the ultimate result will be broken family relationships and a failed business.

One alternative to treating each child equally, and to a form of work related primogeniture, is to establish a separate fund to provide an inheritance for the non-participating child or children. Second to die life insurance policies held in an irrevocable life insurance trust are excellent vehicles to provide a meaningful inheritance for family members who have chosen a different path in life. Another is to shift investment opportunities to the other siblings while at the same time shifting the business to the child who is involved.

III. BUY-SELL AGREEMENTS

Any closely-held business that has two or more owners, regardless of whether they are related, needs a buy-sell agreement. Failure to anticipate the possible death, disability, retirement or private bankruptcy of one of the owners can be disastrous to the other owner or owners because of the disruption to the business. The failure to consider the effect of these events also can have the same effect on the person who is no longer participating in the business because the departing owner or his or her family likely will be unable to capture fair value from his or her portion of the business. Because there are so many issues, advisors are well advised to consult publications concentrating on buy-sell agreement such as: Mercer, Z. Christopher, *Buy-Sell Agreements: Audit Checklist*, Peabody Publishing (2007).

A. Basic Types of Agreements

There are three basic types of buy-sell agreements: entity repurchase, cross purchase and a hybrid of the two. Each type has its strengths and weaknesses, which may be amplified depending on the particular circumstances.

The entity repurchase agreement is structured such that the entity purchases the departing owner's interest upon the triggering event. As a result, the other owners end up with a proportionate increase in their respective ownership of the business. Typically, if the entity has more than two or three owners, a repurchase agreement will be used.

In contrast, the cross purchase agreement has the other owners purchasing the departing owner's interest. When there are only two or three owners, a cross purchase agreement can be less complex, because it does not require the entity's involvement. On the other hand, if there are multiple owners, cross purchase agreements become unworkable.

The hybrid agreement combines the repurchase and cross purchase agreements. The hybrid usually comes into play when the company may have capitalization restrictions which would prohibit the company from making a repurchase of all or a part of the departing owner's interest. Another possibility is that repurchases might be triggered for a variety of different reasons. For example, the agreement might be triggered when an employee/owner's employment is terminated, or when a major owner dies. Depending on the source of funding for the purchase (for example, life insurance versus company funds), the hybrid agreement might provide for a different purchaser for the different events. A hybrid agreement also might give the company or the other owners an option to purchase after which the other would be required to make the purchase if not exercised. The possibilities are endless. The hybrid agreement is essentially a custom agreement drafted to satisfy the requirements of the entity and owners in question.

[3] The obligation certainly does not seem to have been inherited from history. Rather, it seems to have been a societal reaction to primogeniture, which tended to leave daughters and sons other than the first as second class family members.

B. The Relevant Parties

In many businesses, there are many parties to be included in the discussion relating to a buy-sell agreement. They include:

- *The Company* – Yes, the company must be involved. From an attorney's conflict of interest standpoint, the company probably should have its own attorney if it has several owners. Certainly, an attorney representing a majority owner negotiating a buy-sell agreement will not want to represent the company, too.
- *Employee Shareholders* – Not all owners are employees. The employee shareholders likely have the best interest of the company in mind given that their livelihood depends on the company's success. Employee shareholders may have a very small stake in the company and yet are key players in its potential long term success.
- *Passive Shareholders* – Passive shareholders fall into two, maybe three camps. The first camp is composed of investors who have an interest in seeing the company succeed in the long term. The second camp is composed of persons who may have been employed at one time, but are no longer for one reason or the other. If the passive owner depends on the company for his or her income, the passive owner also will care very much for the future of the company. Finally, the passive shareholder may be a family member who acquired the interest through gift or inheritance. Depending on that person's selfish interests, he or she may simply want to extract as much return from that interest as possible and may be a good candidate to buy out at the earliest possible juncture.

Note that a buy-sell agreement and a business succession plan can be crafted without the participation of all owners. In certain situations, the relationships of the various parties might prohibit including all the owners.

C. Code Section 2703 Valuation Issues

Buy-sell agreements, whether for a family owned business or not, are subject to the restrictions of Code section 2703, which ignore, for valuation and transfer tax purposes, restrictions that go too far.

Valuation discounts or defined values generally will not be respected if the buy-sell agreement allows another owner to acquire the interest for less than fair market value or otherwise restricts the right to sell the interest to third parties. *See* Code § 2703(a). The only exception allowed to the general rule is for an agreement that is otherwise a bona fide business arrangement, not a device to transfer the interest to a family member for less than fair market value and is comparable to similar arrangements for persons who have an arm's length relationship. *Id*. § 2703(b).

Granted, buy-sell agreements in the context of a company owned by unrelated persons will more likely be respected because they are generally arm's length transactions. The advisor should nevertheless evaluate the agreement in the context of section 2703 because the agreement must nevertheless meet each part of the test for the exception to apply under section 2703(b).

D. Likely Objectives

The owners of a business entity will have several objectives in mind when they consider the structure of a buy-sell agreement. Because perspective shifts when one is placed in the seller's position as compared to the buyer's position, those objectives probably are not the same and are dependant, in part, on the individual owner's goals. Some of the possible objectives that should be considered include:

- *Marketability* – The owner who anticipates leaving the company first wants to ensure a ready market for his or her interest in the company. Regardless of transfer restrictions that might be placed on ownership, minority interests in small businesses do not have much of a market. A buy-sell agreement that requires the purchase provides a ready market for an otherwise highly illiquid asset.
- *Fair value* – Both the selling and buying owners want fair value. The seller likely has invested much of his or her life in the business and the interest may represent a significant proportion of his or her estate. The seller wants to ensure a reasonable return on that investment and avoid what otherwise could be a forced sale at a low price. The buyer, on the other hand, also wants a fair value. If the price is too high, the company or the buyer will not be able to afford the purchase. The inability to afford the purchase might not present itself immediately. Rather, an unfair price might deplete cash reserves or cash flow to the extent the company or the individual will have insufficient funds to continue the business during lean times.
- *Clear Roadmap* – The buy-sell agreement should provide a clear roadmap specifying the triggering events, a timeline for closing, the appraisal process (or other valuation technique) and the manner in which the parties have agreed to resolve disputes.
- *Valuation* -- The agreement must address how the interest to be sold will be valued. The exact method can be tailored to the client's needs.
- *Funding* – The agreement also should address funding of the purchase price. In the context of death, life insurance is often purchased to provide the funding. But then, someone has to die. Funding also should be addressed for purposes of buying the

interest of an owner who is merely retiring or becomes disabled.

- *Protection from Outsiders* – A buy-sell agreement protects all the owners from being forced to work with outsiders.
- *Irreconcilable conflicts* – Sometimes, an issue will arise that materially hampers the owners' ability to continue working together. A push-pull provision can be used to help the parties avoid litigation if all else fails. The owners also should consider binding arbitration in lieu of litigation.[4]

E. Triggering Events

In an estate planning context, the focus is on the death of an owner. But several other events should be considered as a triggering event, especially in the context of a working entity. Likely candidates for a triggering event include:

- Death;
- Divorce;
- Bankruptcy or insolvency;
- Disability;
- Retirement;
- Termination of employment;
- Voluntary or involuntary transfer of ownership; and
- Irreconcilable conflicts.

F. Valuation Issues

Several options exist for determining valuation. The most common methods are:

- *Appraisal by a qualified appraiser* – Appraisals typically look at the fair market value of the interest as is done in the context of estate taxes. This method probably is the most accurate of the several options for valuation because it will take into consideration the values obtained by some of the other methods.
- *Book Value* – Another method is to base the valuation on the book value of the company. The appeal of this method is its ease and simplicity. In a company that has equipment, buildings and other assets that have been depreciated for income tax purposes, however, the book value likely will produce a very low valuation as compared to the interest's true value. On the other hand, the book value might provide an approximation of the discounts the appraiser might otherwise apply in a fair market value appraisal.
- *Asset Value* – One may also base the company's value for purposes of the buy-sell agreement on the company's underlying assets. This is commonly used when the company's significant assets are composed of real property or other assets that have value in and of themselves. In a service related business or one that is not heavily capitalized, the asset approach will not work. Also, if estate taxes are an issue, however, asset value may present an appraisal that is too high because potential valuation discounts will not be taken into account.[5]
- *Agreed Value* – Typically, an agreement that relies upon an agreed value will provide that the agreed value will be revisited by the owners on an annual basis. Conceptually and in the context of persons who truly follow the golden rule, the agreed value approach should work. The author has found, however, that the tendency is either to undervalue or overvalue the business by large differentials. Also, the owners rarely remember to revisit the agreed value until after a triggering event has occurred. Even if the owners do regularly visit the agreed value, one of them might see the writing on the wall and begin to skew the negotiation to a result that unfairly favors that owner. Still, agreed values can be helpful to lower cost when the buy-sell is triggered and when a set sum (like a life insurance policy) will be used to fund the purchase.

G. Funding Issues

Life insurance agents love buy-sell agreements. Life insurance is almost a necessity in this context. But life insurance can only be used to make the purchase on the death of the owner. The age and health of the owners also affect the ability to fund a life insurance policy. Other funding options must be considered for the other triggering events.

A common technique is to define the terms of payment in the agreement. Typically, a portion is paid down, with the remainder paid over time. Too high of a payment schedule will cause the company cash flow and capitalization issues. Too low of a payment

---

[4] The author believes that arbitration provisions tend to favor the likely defendant. The filing fee for a claim with the American Arbitration Association, for example, is tied to its value. A commercial claim valued at between $75,000 and $150,000 has a total filing fee of $2,600. American Arbitration Association, *Commercial Arbitration Rules, effective June 1, 2010* (available at www.adr.org). A nonmonetary claim has a total filing fee of $4,600. *Id*. The parties also have to pay the regular rates of the arbitrators. *Id*. The author has seen rates in excess of $1,000 per hour for arbitrators in a complex case. Woe to the party who agreed to a panel of three arbitrators.

[5] Of course, if the purpose of the buy-sell agreement is to provide a means of extracting the family wealth from the company and non-related parties (or parties who are not related closely enough), the family will want to maximize their return and should be happy to have an estate tax problem.

schedule will cause the departing owner to be an unwilling private banker. In either situation, the departing shareholder will be at risk of default. Accordingly, the note should be secured, at least by the interest purchased.

Note that too much creativity in the context of a family held business can raise issues under Code § 2701, which attempts to regulate economically preferred interests in a family business situation.

H. Ownership Structure Issues

Most small businesses are taxed as partnerships, which simplifies the planning process greatly. On the other hand, S corporations, which also are taxed as partnerships, have special concerns that must be addressed in any business succession plan. A subchapter S corporation may not have (a) more than 100 shareholders, (b) a shareholder who is not a person (with certain limited exceptions), (c) a shareholder who is a nonresident alien, or (d) have more than one class of stock.[6] Code § 1361(b)(1). Significantly, an irrevocable trust (that is not a grantor trust) can hold subchapter S stock only if it qualifies as either a "qualified subchapter S trust" or an "electing small business trust". *See Id*. §§ 1361(d), (e).

Some entities also have multiple classes of stock or ownership. In the context of entities that are taxed as partnerships (other than subchapter S corporations), classes of ownership that have different levels of economic rights cause significant partnership taxation problems under Code section 704 (the partner allocation rules) and applicable regulations (which run 300 pages or so). Such a structure also may implicate Code section 2701, which addresses the valuation of the gift of certain types of ownership when economic rights differ among classes of that ownership.

I. Issues with Third Parties

The advisor must ensure that the buy-sell agreement does not run afoul of agreements with third persons. The most common example of such a third party agreement is one related to financing the company. Many contain clauses requiring payment in full upon a change of control or due on sale clauses that would be triggered by a buy-sell agreement. Franchise and dealership agreements also may have an effect on the buy-sell agreement. Finally, many professions require the owner to hold a license or a particular type of business be operated by a licensed person. These issues should be addressed during the consultation phase of the planning engagement.

IV. LIMITED LIABILITY COMPANIES (AND LIMITED PARTNERSHIPS)

During the last several years, estate and business planners have increasingly been using limited liability companies ("LLCs") and limited partnerships ("LPs") as the entity of choice for small businesses, asset protection and estate planning. The author's firm, for example, rarely establishes corporations any more. LLCs and LPs are more efficient than corporations, even those taxed as partnerships, for several reasons. First, annual reporting to the state is not required for LLCs and LPs, as is required for corporations. Annual meetings also are not required. Accordingly, less administration is required to keep the books and records of the entity in shape.

Further, a single owner or two owners who are husband and wife may elect that either an LP or an LLC be disregarded for income tax purposes. Two owners, including a husband and wife, may elect that the entity be taxed as a partnership. While a corporation also may elect to be taxed as a partnership under Subchapter S of the Code, the Code has restrictions on the permissible number of owners and the identity of the owner. For example, trusts owning stock in a subchapter S corporation have to have special provisions to avoid disqualifying the corporation. Certain foreign owners also disqualify the corporation from the subchapter S election.

A. Significant (?) Difference between LLCs and LPs

Business entities like LLCs, LPs and corporations provide their owners with a shield of protection. The owner's assets are not subject to claims against the entity, assuming the owner also is not personally responsible for having caused the harm or having guaranteed a debt.[7] Such creditor protection can be referred to as "front door protection". When an entity is owned by more than one person, however, front door protection is not the only concern. The owners also should be concerned about the creditors of one of the other owners somehow acquiring the debtor's interest in the entity. Typically speaking, owners of closely held entities do not wish to be partners with the creditors or ex-spouses of a former partner. The latter type of creditor protection is referred to as "back door protection".

For most intents and purposes, the statutes governing LLCs and LPs seem to provide the same type of back door protection. *Compare* NMSA §§ 53-

[6] Despite the plain statutory language, a subchapter S corporation may have a second class of stock, but only if the only difference is that the second class cannot vote. Code § 1361(c)(4); Regs. § 1.1361-1(l)(2). The economic rights of the two classes must be identical. *Id*.

[7] The statement also assumes that the owner has respected the form of the entity and has not treated it as an alter ego or as a means to defraud creditors.

19-35 (defining the rights of a creditor of a member of an LLC) and 54-2A-703 (defining the rights of a creditor of a partner or transferee of a partner for an LP). But there are differences, which may or may not prove to be material.

In the context of an LLC, the creditor of a member has the right to seek from a court a charging order for payment of the unsatisfied amount of the judgment, with interest. *Id.* § 53-19-35. The charging order does not, however, give the judgment creditor any more rights than an assignee of the membership interest would have under section 53-19-32. Those rights are limited to receiving only the distributions and return of capital to which the assignor would have been entitled to with out the charging order. *Id.* § 53-19-32(A)(2). The judgment debtor retains his or her management rights in the company. *Id.* § 53-19-32(A)(4). Otherwise, the statute governing the rights of creditors of members is silent and does not prohibit the company's operating agreement from altering the judgment creditor's rights. On the other hand, if one reads the New Mexico Limited Liability Company Act as a whole, one will notice that many of its provisions specifically provide when the operating agreement may alter the general rule. It is unclear under New Mexico law to what extent the operating agreement may alter the statutory provisions, when the statute is silent.

The creditor of a partner of an LP, on the other hand, also has the right to seek a charging order from a court. NMSA § 54-2A-703(A). So long as the charging order is in place, the judgment creditor only has the rights of a transferee of a partner. Transferees of partner's rights also are limited to receiving the economic benefits that would otherwise have been distributed to the partner. *Id.* § 54-2A-702(B). Again, the transferor of the partnership interest retains the management rights associated with the transferred interest. *Id.* § 54-2A-702(D).

Unlike an LLC, however, the judgment creditor of a partner in an LP who has already obtained the charging order also may foreclose upon the charging order. NMSA § 54-2A-703(B). The partnership agreement likely may not be drafted to prevent the foreclosure. *See Id.* § 54-2A-110(B)(13) (prohibiting the partnership from restricting the rights of third parties). The statute does provide that another party or the LP may unilaterally redeem the charging order lien anytime before foreclosure. *Id.* § 54-2A-703(C). Interestingly, the statute governing the rights of a creditor in the context of an LP also states that the rights it lists are the exclusive remedies available. *Id.* § 54-2A-703(E).

The issue to determine is which entity, the LLC or the LP, provides better back door protection for its owners. A judgment creditor seems to have greater rights in an LP because of the foreclosure right. But the statement that the rights listed are exclusive makes one wonder if a judgment creditor in the LLC context has other unwritten rights that go further than the rights in an LP. Further, the other partners and the LP itself have the unilateral right to redeem a charging order/lien. It would seem that an LLC operating agreement should be able to give the other members and the LLC the same right. But the statute's silence on the topic is menacing.

Perhaps the answer is to look to the back door protection opportunities afforded by the laws of other states and seek authorization to do business in New Mexico as a foreign entity.

B. Capitalization Flexibility

Some attorneys believe that LPs provide greater opportunity for discounts because the general partner necessarily has full management and control of the LP while the limited partners only have an equity interest. For example, the general partner may have a 1.0% general partnership interest while the limited partners share 99.0% limited partnership interests. Because the 1.0% general partnership interest has so little relative equity, its value is small despite its control. The limited partnership interests, despite having the greater part of equity automatically have less value because of the lack of control. Much planning through the use of sales to intentionally defective grantor trusts and grantor retained annuity trusts can be accomplished when the control and equity are divided in this manner.

The author believes, however, that the same result can be achieved through an LLC. Instead of having a single class of members, the operating agreement would simply provide for two classes, a small percentage with all the control, and the remainder having almost all the equity.[8] As a result, a member who owns a majority of the economic interest will nevertheless lack control. One must be careful, though, to avoid tinkering with the allocation of the economic benefits of the interests to avoid problems under the partnership allocation rules of Code section 704 and its Byzantine regulations.

C. Valuation Discounts

In the context of transfer entities and family owned businesses, an important attribute of LLCs and LPs is that partial interests of such entities may be

[8] One may use the same technique if the entity is a subchapter S corporation. Typically, subchapter S corporations may have only one class of stock. The one exception is that it may have one that is voting and one that is non-voting. Otherwise, the two classes must have the same economic rights.

subject to valuation discounts.[9] Valuation discounts are proper because taxation depends on the fair market value of the asset transferred. For purposes of transfer taxes, "fair market value" means "the price at which the 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". Regs. §§ 20.2031-1(b), 25.2512-1.

In the context of a business entity of which there are two or more owners, the asset to be transferred is a partial interest in the whole. Any buyer of that interest would end up being forced to share the whole with other persons. The transferor also may be unable to control the business because he or she would not own a controlling interest. As a result, the buyer's investment would be subject to the competence and goodwill of the owners who are in control. Transfer restrictions also might limit the buyer's ability to sell to someone else. As such, an already illiquid asset is rendered even more viscous. The transferor also might not be able to transfer the interest freely. No willing buyer having knowledge of the circumstances would be willing to pay a price based simply on the transferor's proportionate interest in the business. The partial interest simply is not worth that much.

Regulating control is a fairly straight forward affair, assuming the drafter is careful in drafting. The most basic agreements simply equate control with greater than 50% of the interest in the company. Others require supermajority or unanimous decisions for major items. For example, the sale of the company's real estate might be subject to a supermajority vote. In the context of business valuation, control is generally associated with an ability to realize the fruits of an investment. For example, both the authority to declare a distribution of capital and to sell a major company asset is associated with control. If enough major decisions are subject to the vote of a supermajority that is greater than the proportionate interest held by the owner, the more likely the owner lacks sufficient control over the company despite having a majority interest.

In many small businesses, transfer restrictions also are of vital importance to ensure that the owners, who typically are involved in the business, are not forced to share control and profits with non-participating owners, who may or may not be pleasant to deal with. One common example of the type of transferor business owners (related or not) likely will want to protect against is the former spouse of one of the owners. Family businesses also likely will want to restrict transfers to non-family members.

Restrictions can be so restrictive, however, as to be ignored for valuation purposes. Under Chapter 14 of the Code, transfer restrictions, including options or other agreements giving another person the right to acquire property at less than its fair market value, are generally disregarded for valuation purposes. *See* Code § 2703(a). The general rule has one exception. The restriction, option or agreement is upheld for valuation purposes only if it is (1) a bona fide business arrangement; (2) not a device to transfer the property to family members for less than full and adequate consideration; and (3) comparable to similar arrangements entered in arm's length transactions. *Id.* § 2703(b). The goal in drafting transfer restrictions, therefore, is to limit them to the types of agreements that unrelated parties would seek in a small business arrangement.

An example of a restriction that goes too far is one that prohibits the owner from transferring the interest in the business to anyone other than another family member. The IRS argues, and the courts tend to agree, that such restrictions deprive the owner from realizing his or her economic interest in the entity, especially if the owner lacks control. To get around this argument, many modern agreements are drafted to include a short option period during which either another owner or the entity itself may purchase the interest at the same price and on the same terms as a bona fide offer from a third party. Once the option period expires, the selling owner may then sell the interest outside the family (or other group of owners). The author is unaware of any litigation that has tested this strategy, yet.

As is the case in many areas of tax law, the government began to view a straightforward interpretation and application of the law as abuse and regularly attempts to challenge creative structures of control and restrictions on transfers. Both the current Forms 706 and 709 require the taxpayer to state whether the return reports a valuation discount. The author understands that such returns automatically receive extra scrutiny from the IRS. Before the advisor gets too creative in dividing control or devising restrictions, he or she should consult case law in which the IRS has challenged the structure of LLCs and LPs under Code sections 2036 (retained life estates) and 2038 (transfers taking place at death) and under Chapter 14 (special valuation rules for intra-family transfers and transfer restrictions).

Advisors also should be familiar with the economic substance doctrine, and its recent

[9] One must recognize that a partial interest also might be subject to a valuation premium. For example, a 1.0% interest in an entity that controls the entity's management and makes important decisions like whether to make a distribution of income to owners should be valued at premium, when compared to interests that lack control.

codification.[10] *See* Code § 7701(o). A transaction has economic substance only if (a) the transaction changes the taxpayer's economic position in a meaningful way; and (2) the taxpayer has a substantial purpose for entering the transaction, both ignoring the tax effects of the transaction. *Id*. § 7701(o)(1). Perhaps most troubling in this area is the contemporaneous enactment of a 20% penalty for the disallowance of a claimed tax benefit by reason of a transaction lacking in economic substance and a 40% penalty for failure to disclose the relevant facts surrounding a noneconomic substance transaction. *Id*. §§ 6662(b)(6) (20% penalty) and 6662(i) (40% penalty). Unlike other understatement penalties, there is no requirement that the understatement be substantial for the penalty to apply. *Compare Id*. §§ 6662(b)(2), (3), (4) and (5) *with* 6662(b)(6). The penalty is therefore a strict liability penalty.

Please see Section VIII, below, for a discussion regarding fair market appraisals of businesses.

Ultimately, if an agreement governing the family business entity is drafted correctly, and the owners actually respect the form of the entity and have a real business purpose for the structure and the transactions that have taken place, the propriety of a valuation discount should withstand any scrutiny the IRS chooses to apply.

D. Tiered Entities and Multi-Level Discounts

With sufficient time (and will on the client's part), a client's business and investment holdings can be structured into multiple tiers, with a holding company at the top. Ideally, the client will hold an interest in the holding company that lacks control and is subject to reasonable transfer restrictions. The holding company will in turn also hold interests in the underlying businesses which also lack control and are subject to transfer restrictions. The other owners of the entities are family members or trusts for their benefit that acquired equity through contribution of capital, or through other estate freeze techniques as described below.

The major goal of establishing a holding company structure is to consolidate the family's wealth and management success to provide leverage for building future wealth. A minor goal, which is a consequence of the overall goal, is to secure valuation discounts at each entity tier. Invariably, the IRS will argue that the discounts at each tier are impermissible because they are duplicative. Case law, however, regularly approves of multi-level discounts. Discounts at each level can provide a cumulative discount that is much greater than would otherwise have been available.

The various paths for achieving the tiered structure are multitudinous. The propriety of multi-level discounts also depends in large part on the unique facts of a particular case. A good starting point for reviewing recent case law for a road map of issues to avoid is found in the following paper: Rabe, James G., *Multi-Level Discounts for Tiered Entities—Insights from Historical Case Law*, 35 ACTEC Journal 136 (2009).

V. ESTATE FREEZE TECHNIQUES

A. General Concept

An estate freeze technique is one in which the goal is to shift future appreciation of an asset to the next generation with minimal or no transfer tax consequence to the client. Such techniques are particularly useful to transfer the assets that generate wealth for the family or those that have significant appreciation potential. They also are more effective in a low interest rate environment like that which exists today. They work by replacing the asset to be transferred with a fixed income asset like a promissory note or an annuity.

A simple sale to a family member certainly freezes the value of the client's estate. The wealth generator, which carries significant risk and upside potential, is traded for cash, a promissory note or other liquid assets. Such a simple solution, however, will generate income tax liability for the recognized capital gain. While the current long term capital gains tax rate is low when compared to most of the marginal rates for regular income, it is still a tax cost that must be considered in any transaction. A simple sale also raises gift tax potential. The seller must obtain a qualified appraisal of the business to establish that it has been sold at fair market value, and, to be safe, should file a gift tax return to trigger the statute of limitations.

The goal here is to avoid taxation at any rate and to preserve the asset within the family. This goal can be satisfied by the following two techniques, sales to intentionally defective grantor trusts and grantor retained annuity trusts.

B. Sales to Intentionally Defective Grantor Trusts

1. <u>Background</u>

When the income tax began in 1913, it began as a progressive tax like it is today. In stark contrast with its subsequent history, including its present state, the maximum rate in 1913 was only 7%. Tax Foundation, Federal Individual Income Tax Rates History, Nominal Dollars, Income Years 1913-2011 (available at

[10] The codified version of the economic substance doctrine applies to transactions occurring after March 30, 2010. The common law version arguably applies to all previous transactions.

http://www.taxfoundation.org/publications). In 1916, the maximum rate increased to 15%. *Id*. It stayed modest for only one year more. In 1917, the maximum rate jumped to 67%. *Id*. In 1918, the maximum rate jumped again to 73%. *Id*. In 1945, the maximum rate jumped to its highest level of 94%. *Id*. From 1954 to 1964, the maximum rate was 91%. *Id*. The maximum rate did not drop below 70% until 1982, but it was still as high as 50%.[11] *Id*.

During the periods of punitive tax rates, smart lawyers soon figured out that the high income earners could shift taxation to lower bracket family members and yet retain a certain amount of control over the asset by setting up trusts. The trusts were designed in such a way as to give the income to a taxpayer in a lower bracket, but avoid completing a gift so as to avoid a transfer tax. The IRS soon discovered the technique and Congress passed the grantor trust rules found in Code sections 671 through 679. The policy behind these rules was to require the person who had "control" of the income producing asset to pay taxes at his or her marginal rate on the income produced by the asset despite that the asset might be held in trust for another person and that other person might receive the income. In effect, the grantor trust rules prohibited (through taxation) the type of smart income shifting the planners had figured out.

If one fast forwards to the present, one finds that the highest marginal income tax rates have decreased substantially from even 1981. The compressed rates have removed much of the temptation to shift income to lower bracket taxpayers. In fact, the compressed rates have rendered the grantor trust rules rather innocuous to most taxpayers. Because those rules are rather meaningless from a practical perspective for high income earners, the compressed rates also have opened up the possibility of planning to transfer assets with no transfer tax consequence through sales to intentionally defective grantor trusts ("IDGTs").[12]

Sales to IDGTs come into play when the client has either used up all of his or her lifetime gift tax exemption or, for one reason or another, wishes to preserve as much estate tax or GSTT exemption as possible. They can be used because the sale, if structured properly, does not trigger either an income tax consequence or a transfer tax consequence.

Generally speaking, the owner will sell an income producing asset to an IDGT in exchange for a promissory note, which typically requires only interest payments with a balloon payment at the end. The efficacy of the sale, from a transfer tax perspective, depends primarily on two factors. The first and most important is the likelihood that the transferred asset is able to generate sufficient income to service the note. If income is insufficient, principal will have to be used to pay interest. If so, there will soon be a death spiral and the buyer will have used the asset purchased to pay off the note. The second controlling factor is the differential between the income generated by the asset and the minimum interest rate that can be charged without a deemed gift. The lowest rate is set monthly by the IRS pursuant to Code § 7872. If the permissible interest rate goes too high, simple economics will prevent the strategy from working.

The current economic outlook of the United States presents an incredible opportunity for IDGT planning. The October 2011 section 7872 rate for mid-term notes (greater than one year, but no more than nine years) is only 1.19%, down from a high for the year of 2.49% in April. *Compare* REV. RUL. 2011-22 (October rate), REV. RUL. 2011-10 (April rate). This is an incredibly low rate (it appears to be the lowest rate in the last decade) and has no real place to go in the future, but up. If there ever was a time to make a sale to an IDGT, that time is now.

The technique has significant advantages over other means of transferring the family business or other assets beyond the tax benefits noted above. *See* Hodgman, David R., *IDGTs on Steroids: Current Conditions Strengthen Benefits*, 38 Estate Planning No. 7, 3 (July 2011); Akers, Steve A., *Transfer Planning, Including Strategies to Maximize Benefits of GRATs and Sales to Grantor Trusts Given Recent Market Declines*, Dallas Estate Planning Council, May 2009 at 32-33.[13] First, there is no survival requirement as is present with the grantor retained annuity trust, which will be discussed below. Second, the transfer is exempt from the generation-skipping transfer tax ("GSTT"). Finally, cash flow can be retained within the company for continued reinvestment through the use of an interest only balloon note to finance the sale.

Several other planning techniques and factors can contribute to the success of the strategy. Selling an

[11] The author finds it rather ironic that the period of 1945 through 1981 also represented the height of the cold war. As pointed out above, the Communist Manifesto called for just such a progressive tax on income.

[12] The IDGT name comes from the fact that the drafter has intentionally included a power that subjects the grantor to income tax despite that the transfer has been completed for transfer tax purposes.

[13] Mr. Akers is a prominent national authority in estate planning. His employer, Bessemer Trust Company, makes Mr. Akers' papers and commentaries available to estate planning professionals at the company's website. www.bessemer.com. The paper cited above is the best discussion the author has read regarding estate freeze techniques. The author freely admits indebtedness to Mr. Akers' careful work in the area.

interest in a business that lacks control and is subject to transfer restrictions, for example, properly give rise to valuation discounts during the appraisal process. The resulting note and required interest also will therefore be discounted. If the business then distributes real dollars as income to the IDGT, the trust can pay the note with dollars that have not been subject to the discount. The owner will have not only frozen the value of his or her estate, but also will have frozen the value at a discount.

The grantor trust rules also allow for a "back-door gift" free of any transfer tax. The owner who sold the asset must pay the tax on the income generated by the trust and which the beneficiary would otherwise have paid. As a result, the beneficiary has that much more liquidity with which to service the promissory note to the previous owner. There is no gift tax consequence to paying taxes under the grantor trust rules. *See* REV. RUL. 2004-64.

2. <u>Component Parts of a Sale to an IDGT</u>

A sale to an IDGT has several component parts, as follows:

- The establishment of a grantor trust and its funding with sufficient assets;
- The appraisal of the business or portion of the business to be sold;
- The exchange of the business (or portion) to the grantor trust in exchange for an installment note; and
- The payment of the installment note, hopefully during the previous owner's lifetime.

Each component part will be discussed in turn.

3. <u>Grantor Trusts</u>

Typically speaking, irrevocable trusts are taxed directly on their income. The trust can typically avoid taxation if it distributes income to a beneficiary during the tax year. The beneficiary then becomes responsible for paying the tax. A "grantor trust", in contrast, is taxed differently because the grantor had retained certain powers or rights over the trust such that the grantor, and not the trust or its beneficiaries, is treated as the owner for income tax (but not necessarily transfer tax) purposes and is responsible to pay income taxes under the grantor trust rules of Code sections 671 through 679. The most common example of a grantor trust is the standard living or revocable trust because the grantor has retained the power to revoke the trust. *See* Code § 676(a).

The following powers or rights cause a trust to be a grantor trust. As is the case with just about any tax provision, there are exceptions to the general rules stated below. The list is non-exclusive.

- A reversionary interest in the trust income or principal, the present value of which exceeds five percent of the property in question, Code § 673(a);
- The power of the grantor or a nonadverse party to control the beneficial enjoyment of trust income or principal, without the approval or consent of an adverse party,[14] *Id*. § 674(a).
- The power of the grantor or a nonadverse party to purchase, exchange or otherwise deal with or dispose of trust income or principal for less than adequate consideration without the consent of an adverse party, *Id*. § 675(1);
- The power of the grantor or a nonadverse party to borrow trust income or principal without either adequate interest or adequate security, *Id*. § 675(2);
- The power of anyone, in a non-fiduciary capacity, to vote stock in a company in which the holdings of the grantor and the trust are significant, without the consent of any person acting in a fiduciary capacity, *Id*. § 675(4)(A);
- The power of anyone, in a non-fiduciary capacity, to reacquire trust principal by substituting other property of an equivalent value, without the consent of any person acting in a fiduciary capacity, *Id*. § 675(4)(C);
- The power of the grantor or a nonadverse party to revoke the trust, *Id*. § 676(a);
- The possibility that the grantor or his spouse might receive a distribution of trust income, without the consent of an adverse party, *Id*. § 677(a)(1), (2); and
- The possibility that trust income may be applied to the payment of premiums for life insurance on the life of either the grantor or his spouse, without the consent of an adverse party, *Id*. § 677(a)(3).

The trick, in the context of business succession planning, is to pick a power that does not also cause the trust principal to be included within the grantor's gross estate for transfer tax purposes. Fortunately, the rules governing income taxation and estate taxation do not overlap, completely. Still, one must keep in mind that the estate tax with respect to a particular asset can be avoided only if the decedent really did depart with

[14] A "nonadverse party" is any person who is not an "adverse party". Code § 672(b). An "adverse party" is a person "having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power", including a person who holds a general power of appointment over the trust property. *Id*. § 672(a).

ownership and control of the transferred property. In 1949, the Supreme Court stated as much:

> An estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, without possible reservations, parts with all of his title and all of his possessions and all of his enjoyment of the transferred property. After such a transfer has been made, the settlor must be left with no present legal title in the property, no possible reversionary interest in that title, and no right to possess or enjoy the property then or thereafter.

Commissioner v. Church, 335 U.S. 632, 645 (1949). Despite the client's wishes (and the false promises of some tax planners) one cannot be a hog when it comes to control, because hogs get slaughtered.

a) Drafting for Grantor Trust Status

The following types of powers or rights, among certain other types not relevant here, cause estate inclusion under Chapter 11 of the Code: transfers with retained life estates (Code § 2036), transfers taking effect at death (*Id*. § 2037), revocable transfers (*Id*. §2038), annuities (*Id*. § 2039) and general powers of appointment (*Id*. § 2041). As long as the grantor's power or interest in the trust does not amount to one of these types of interests, the trust will generally be excluded from the grantor's gross estate despite that the grantor is considered the owner for income tax purposes. The comparison reveals that a handful of the grantor trust rules do not cause estate inclusion.

A couple of grantor powers can be rejected outright as causing estate inclusion. Reversionary interests under section 673 and the power to revoke under section 676 will not work. The possibility of using trust income to pay life insurance premiums under section 677 does not seem to address the practicality of the situation, so that power can also be eliminated.

Any power retained by the grantor automatically is suspect. For example, a grantor's power to affect the beneficial enjoyment of property under section 674(a) sounds very much like a power of appointment. *See* Regs. § 20.2041-1(b)(1) (a power to affect the beneficial enjoyment of trust property is a "power of appointment"). One possibility would be to ensure that the grantor's power to affect beneficial enjoyment is limited to a fiduciary duty with an ascertainable standard. *See* Code § 2041(b)(1)(A), *also see* Regs. §§ 20.2041-1(c)(1) and (2) (both excluding such powers from the definition of general powers of appointment). But Congress seems to have anticipated this loophole and provided that powers limited by an ascertainable standard do not trigger the grantor trust rules. Code § 674(b)(5).

While there are some other complicated possibilities for creating a grantor trust but at the same time avoiding estate inclusion, the most straightforward, and perhaps most importantly, the most tested, methods of achieving the desired results are to:

- Give a nonadverse party the right to add beneficiaries without the consent of an adverse party under Code § 674(a);
- Give a nonadverse trustee the power to make a loan to the grantor without adequate security for the loan under Code § 675(2); and
- Give the grantor, in a non-fiduciary capacity, a power to substitute property owned by the trust with other property of equal value and without the consent of an adverse party under Code § 675(4)(C)[15]; and
- Give the grantor's spouse, in a non-fiduciary capacity, the power of substitution and without the consent of an adverse party.

The IRS has blessed the third possibility under Code §§ 2036 (retained life estates) and 2038 (revocable transfers), despite that it is the grantor who has the power of substitution under certain conditions. *See* REV. RUL. 2008-22. The trustee must have a fiduciary obligation under either local law or the trust agreement to ensure that the exchanged property is in fact of equivalent value. *Id*. The trust also must provide that the grantor cannot exercise the power in such a manner as to shift benefits among the trust's beneficiaries. *Id*. A trustee's duty of impartiality among the beneficiaries (both current and remainder beneficiaries) and the power to invest the trust principal creates a safe harbor to avoid the shifting of benefits problem. *Id*.

The following two paragraphs have been used to make an irrevocable trust a grantor trust. The first is based on the holding in REV. RUL. 2008-22.

> **[Option 1]** The Grantor may, in a non-fiduciary capacity, reacquire any trust property contributed to the trust by exchanging it for other property of equivalent value at any time before termination of the trust. The Grantor may not, however,

[15] Note that a non-fiduciary power of substitution should not be used in the context of an irrevocable life insurance trust. Under Code § 2042, life insurance policy proceeds are included if the decedent retained an incident of ownership over the policy. One type of incident of ownership is the possibility of a reverter.

exercise this power in any manner that might shift the beneficial interests of any of the beneficiaries of the trust. Grantor's agents may exercise this power if the document appointing the agent specifically refers to this power. Grantor may disclaim, in whole or in part, this power by written notification delivered to the Trustee. The Trustee shall ensure the Grantor's compliance with the terms of this power, if exercised, by satisfying itself that any properties acquired and substituted by the Grantor are in fact of equivalent value.

[Option 2] ___________ (a nonadverse third-party) may, in his or her sole discretion, add as a Secondary Beneficiary of any trust share the spouse of that share's Primary Beneficiary, one or more of the spouses of that share's Secondary Beneficiaries, or both. **[or]** one or more qualified charitable organizations within the meaning of Code Sections 170(c), 2055(a) and 2522(a). The nonadverse third party may exercise the power to add one or more beneficiaries in a non-fiduciary capacity and without regard to the effect such addition may have on any existing or contingent beneficiary. The nonadverse third party also has the power to remove an additional beneficiary named pursuant to this Paragraph at any time and for any reason. This power shall terminate on the Grantor's date of death.

b) Typical Trust Options

The trust designed to purchase the business should be drafted in the normal course for any inter vivos trust that is designed to hold a gift of assets and remove those assets from the grantor's estate. The typical trust may have the following structure:

- *Beneficiary* – Members of the second generation are usually the primary beneficiary or beneficiaries (*i.e.*, the beneficiary whose health, education, maintenance and support come first). The child's descendants many times are secondary beneficiaries. The author recommends that each child of the grantor have a separate share or trust.
- *Trustee* – The relevant child should be able to be the trustee, if the power to make discretionary distributions is limited to an ascertainable standard. There is some concern under Code § 678, however, that the sole trustee/beneficiary might be treated as the owner of the trust. Section 678 provides that a person other than the grantor is treated as the owner if he or she has sole discretion to distribute trust income or principal to him or herself. Code § 678(a)(1). The Grantor should not, under any circumstances, be the trustee, in the context of a sale to an IDGT.
- *Distributions of Income* – Income distributions may either be mandatory or discretionary. Practically speaking, income taxation of the trust's income in this context does not drive the distribution of income regardless of which method of distribution is chosen. The grantor will be taxed regardless of whether the income is distributed and regardless of whether the income is distributed at all. The major difference between the two options (mandatory versus discretionary distributions) is that the Trustee who has discretion may accumulate income if that makes sense under the circumstances. Avoidance of the beneficiary's creditors may be an example of why the Trustee will choose not to distribute income.
- *Distributions of Principal*. The Trustee is usually granted discretion to distribute principal for the beneficiary(ies)'s health, education, maintenance and support. Independent Trustees sometimes are granted discretion to make principal distributions for other reasons that go beyond ascertainable standards. In the context of a sale to an IDGT, principal distributions probably should be prohibited until the installment note is paid off.
- *Crummey Withdrawal Powers*. Some commentators are concerned that *Crummey* withdrawal powers potentially destroy the trust's grantor trust status with respect to the grantor under Code § 678. The IRS has issued, however, several private letter rulings coming to the opposite conclusion, and many commentators feel that the risk is low. Withdrawal powers can be a crucial way to seed the trust over time with no transfer tax cost and therefore may be worth the risk.
- *Termination*. The trust typically will terminate upon the primary beneficiary's death. But the option of terminating the trust upon satisfaction of the promissory note used to purchase the business should be considered. The risk of audit is decreased substantially if the note is paid and the IDGT is terminated all before the death of the grantor.
- *Disclaimer of Grantor Trust Status*. The drafter should consider including an option allowing the Grantor to disclaim the power causing the trust to be a grantor trust. *See* REV. RUL. 77-402 (blessing such an option). Such a provision will allow the grantor more flexibility if he or she desires to stop being responsible for the income taxes generated by the trust.
- *Distribution upon termination*. Typically, grandchildren or other family members are appointed as the remaindermen. Appropriate provisions to

handle contingencies (like the death of a child leaving grandchildren) also are provided.

Many options exist and are limited only by the concept of general powers of appointment and the imaginations of the client and the drafting attorney. Because space is limited and the author only has a limited imagination and little creativity, this paper will treat such options as outside its scope.

c) Funding

Adequate funding of the IDGT is critical to the technique's potential success. Most commentators believe the trust should have assets worth at least ten percent of the value of the property to be purchased. The belief apparently goes back to a 1995 Private Letter Ruling (PLR 9535026) in which the IRS had required the applicants to seed the proposed IDGT with 10 percent. One also may make an analogy to Code § 2701(a)(4), under which the seeding amount should be 11.1%. The ultimate question is whether the promissory note represents debt or equity and the likelihood the debt will be repaid. One should look at the entire transaction and determine whether a disinterested third party would make the same loan (ignoring the interest rate). Assets that secure the note certainly make the transaction more like the real world.

Ideally, the funding of the IDGT would not cause any transfer tax consequences. Such consequences cannot be avoided, however, if the planning starts too late. The planning process therefore should take place as early as possible and possible sales to IDGTs should always be contemplated for the future. For example, a husband and wife can transfer $260,000 to a grantor trust with *Crummey* withdrawal rights over a ten year period. Even if the trust made no return in its investments, it could finance a $2,500,000 purchase.

Another, untested, method is to set up a grantor trust with two shares. *See* Dunn, Such & Park, *The Incomplete Equity Strategy May Bolster Sales to Grantor Trusts*, 34 Est. Pl. 39 (2007). One share, drafted in the normal course, will be minimally funded. The second share, will be funded with the seed amount to satisfy the 10% minimum. Importantly, the grantor will retain a limited testamentary power of appointment over the second share. The power of appointment prevents the second share from constituting a completed gift and avoids an immediate transfer tax. The seed money is then used to secure the sale to the IDGT portion of the trust, which receives all the equity. The result is a fully funded trust to support the sale without a transfer tax consequence. Of course, the seed money will be included in the grantor's estate under Code § 2037 as a transfer that is completed at death.

Careful thought also should be given to the type of asset that is used to seed the IDGT. One certainly may be tempted to fund the IDGT initially with a partial interest in the family business to leverage valuation discounts associated with minority interests and transfer restrictions. One must be aware, however, that the Gift Tax Return that must be filed in association with the initial funding must report the valuation discount. The author understands that such returns automatically receive extra attention at the IRS and the risk of audit likely is increased substantially. The safer practice is probably to seed the IDGT with cash. With cash as the initial seed, the IDGT likely will have sufficient liquid assets to make the first several years of payments on the note without having to make payments on the note in kind.

4. Appraisals

Please see the discussion regarding appraisals of businesses in Section VIII, below.

5. The Promissory Note

The flexibility of the promissory note used to finance the sale of the company is the strength of the sale to an IDGT technique. The typical structure is:

- *Obligor* – the trust.
- *Payee* – the grantor.
- *Security* – both the asset sold to the trust and the other assets of the trust.
- *Guarantor* – none.
- *Interest rate* – the applicable rate under Code § 7872, which is published monthly by the IRS.[16]
- *Term* – 9 years. This is the maximum length of an obligation that qualifies for the mid-term AFR rate under Code § 7872.
- *Payment schedule* – annual payments of interest only, balloon at the end of the term. Do not make payments dependent on performance of the underlying asset. Such a provision raises section 2036 (retained life estate) concerns.
- *Form of payment* – cash or in kind. Most promissory notes require payments in cash. To provide greater flexibility, the note should allow payment in kind, dependant upon a qualified and independent appraisal of the property used to make the payment.[17]
- *Demand rights* – the payee may demand payment at any time.

6. Reporting Concerns

[16] The latest section 7872 rates are found in REV. RUL. 2011-22

[17] The IDGT should avoid, if possible, making payments in kind because such payments will effectively reverse the sale to IDGT technique.

Unfortunately, appraisals of hard to value items like business interests, especially those interests that lack control and are subjected to transfer restrictions, are by no means objective. Invariably, it seems that no matter how honest and forthright the client, the appraiser and the planners try to be, the IRS will see things differently.[18] The goal then becomes one of developing evidence to support the taxpayer's position, to be quiet if permissible and to keep a low profile.

The sale to an IDGT technique allows for all three goals to be accomplished. As discussed elsewhere in this paper, an appraisal will serve as the evidence to support the taxpayer's position. But the IRS may never see the appraisal and may never realize the transaction took place, all because the taxpayer merely followed the law. To accomplish this result the following steps (or non-steps) should take place:

- Make only gifts of cash that qualify for the annual exclusion to the IDGT and to other persons during the year or years of funding the trust. No gift tax returns will be required. As an alternative that raises the risk of audit, but lessens the concerns surrounding Code § 678 and *Crummey* withdrawal powers, fund the IDGT with a taxable gift of cash and report the gift on a gift tax return.
- Because the IDGT is a grantor trust, refrain from obtaining a separate federal tax identification number for the IDGT. The grantor will simply report the income from the IDGT's liquid investments and the income of the sold business on his or her personal income tax return. The flow of income from the business through the IDGT will be essentially transparent to the IRS because income is allocated to taxpayers, not owners.
- Do not report the sale on an income tax return. There is no sale, for income tax purposes, to report. Do not report the interest payments from the IDGT to the grantor on an income tax return. Again, there is no income to report.

The result will be that, at the most, the IRS will have received (1) copies of Forms K-1 over the years that identify the partner of the business as being the IDGT, but reporting all the income on the grantor's tax identification number; and (2) a gift tax return showing a simple cash gift to the IDGT. The estate tax return will not change the result. Part 4 of Form 706 for deaths during 2011 will not require disclosure of any further information regarding the transaction if the note has been paid and the IDGT has terminated. Question 10a, which seeks information regarding whether the decedent owned any interest in a partnership, might have to be answered "yes", depending on the situation, but that will only trigger a requirement to reveal the ownership structure of the partnership at the time of the grantor's death. Question 12a, which seeks information about any trusts established by the decedent, only requires a "yes" answer if the trust was "in existence at the time of the decedent's death". Questions 12e also may be answered "no" because it only seeks information regarding sales of business interests to a trust in existence at the time of the decedent's death.[19]

If, on the other hand, the grantor determines to draft a trust that will extend beyond his or her life expectancy, the grantor should be aware that the transaction must be disclosed on his or her estate tax return. Under Part 4 of the 706, Question 12a will be answered "yes" because the IDGT is still in existence. Question 12e also must be answered "yes" because the sale was made to a trust still in existence. These answers may cause a curious examiner to take a closer look at the sale to the IDGT. To reduce the risk of audit, the grantor should report the sales transaction on a timely filed gift tax return. The purpose of the gift tax return is not to report a taxable gift because the grantor's position is that no taxable gift took place. Rather, it is to trigger the three year statute of limitations for the IRS to contest the valuations reported. Otherwise, the IRS may contest the valuation as part of the estate tax audit. Further, gift tax returns are much less likely to be audited than an estate tax return, so it is strategically better to report earlier than later.

7. <u>Defined Value Clauses</u>

Finally, the grantor should consider a handful of defined value techniques intended to reduce the cost of any subsequent assessment of gift tax due based on the argument that the appraisal of the sold asset was too low.

---

[18] Anecdotally, it certainly seems that the IRS does not view itself as having a duty to achieve the right and just result. Rather, it seems to view its role as a zealous advocate against the taxpaying citizen and in favor of increased tax revenue. *Cf. Christiansen v. Commissioner*, 586 F.3d 1061, 1064 (8th Cir. 2009) (chastising the IRS and stating that "[T]he Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws."). Granted, the IRS's *modus operandi* likely is based upon an equally well founded, yet still anecdotal, belief that tax payers are dishonest and will do virtually anything to avoid paying taxes. In the end, it seems that a handful (perhaps several handfuls) of dishonest taxpayers have ruined things for the rest of the honest public.

[19] Note that the IRS is constantly tweaking Form 706. Sometime in the future, it may decide to ask the right question that would require disclosure of the transaction.

Be aware, though, that the IRS regularly argues that defined values designed to lessen the potential impact of a possible tax audit and consequent tax assessment are against public policy. The stated public policy is that the taxpayer should not be able to create what is in essence a fictitious contingency that would avoid further taxation and that is triggered only if the IRS successfully contests the return. Because the IRS has limited resources, it should and must allocate those resources to maximize return of its actions. If a particular defined value clause is upheld, it would make no economic sense for the IRS to waste its resources in auditing the return in question. As a result, the taxpayer would be able to avoid taxation, not because it has reported real values, but because of the legal fiction. The ultimate result would be that taxpayers would hide behind the fiction of a defined value clause and evade taxation with impunity. In simple terms, the IRS lumps all taxpayers together as dishonest. The law in this area is moving fast, but seems to be trending in favor of the honest taxpayer. *See, e.g., Petter v. Commissioner*, ___ F.3d ___, 2011 U.S. App. LEXIS 16098 (9th Cir. Aug. 4, 2011); *Hendrix v. Commissioner*, T.C. Memo 2011-133 (2011); *Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009). Readers are strongly cautioned to research the area carefully before relying on a defined value clause.

Possible defined value clauses that can lessen the sting of a mistaken valuation can be broken down into two basic categories. The first defined value clause relies upon separate shares built into the IDGT. The first share is drafted in the normal course. The grantor has a limited power of appointment over the second share, resulting in an incomplete gift for any transfer to the second share. The sale is structured such that the first share receives the sold property, which should be 100% of the transfer. The defined value clause states, however, that a percentage (perhaps 90%) of any gift after date X (after the initial seeding but before the sale) is given to the share that constitutes no taxable gift. The remainder of the gift goes to the share with a gift tax consequence. The goal is to lessen the impact of a mistaken valuation rather than to eliminate it and thus reduce the impact of the public policy argument.

The second defined value clause works with a disclaimer. The trust will provide that any disclaimed gift to the trust will pass to someone else for whom there would be no gift tax consequence. Potential recipients of the disclaimed portion could be the grantor's spouse, charity or the grantor. After the sale is made, the beneficiary of the IDGT would disclaim a percentage of any gift to the trust in association with the sale.

C. Sales to Beneficiary Grantor Trusts

While sales to IDGTs have been around for some time and are generally accepted as a relatively safe method for transferring assets with no tax cost, the sale to a beneficiary grantor trust ("BGT") is a relatively new idea that has not yet been tested. A BGT is a trust of which the beneficiary is treated as the owner for income tax purposes under the grantor trust rules. It is, in effect, the converse of the IDGT. The concept is based on Code section 678(a) which states that a person other the grantor is treated as the owner for income tax purposes if that person has or had a general power of appointment over the trust.[20]

Typically, a third party, such as a parent, establishes an irrevocable trust for the business owner. The trust is drafted such that the business owner does not have a general power of appointment over the trust other than a lapsing *Crummey* withdrawal power.[21]

[20] If the grantor is treated as the owner under other provisions of the grantor trust rules, the grantor's status usually trumps the application of Code section 678. *See* Code § 678(b) (stating as much). Therefore, the trust must be drafted to avoid IDGT status.

[21] A lapsing *Crummey* withdrawal right is a general power of appointment over that portion of the trust subject to the power. *See* Regs. § 20.2041-1(c)(1) (defining "general power of appointment"). To the extent the power holder dies during a period in which he or she has a withdrawal right, the right is included in his or her estate for estate tax purposes. Code § 2041. Under Code section 2514(e), the lapse of a general power of appointment is a release of that power. Consequently, the power holder is deemed to have transferred the property subject to the withdrawal power. *Id*. § 2514(b). On the other hand, the lapse of a general power of appointment that does not exceed $5,000 or 5% of the trust assets is not considered a release of the power. *Id*. § 2514(e).

A common method for minimizing the tax consequences to the power holder is to draft a "hanging power". In this technique, the power holder is given the right to withdraw the gift to the trust, up to the annual exclusion amount (currently $13,000). The power will lapse if not exercised after a certain period, typically 30 days, but only to the extent of $5,000 or 5% of the trust's value. For each subsequent year, the power again lapses up to $5,000 or 5% of the trust.

A simple example illustrates how the hanging power works. In year 1, the grantor makes a gift of $12,000 to a trust with one beneficiary who holds a hanging power as described above. The trust has no other assets and the grantor makes no further contributions to the trust. In year one, the power holder has the right to demand distribution of the entire $12,000, but does not do so. Thirty days after the transfer, the beneficiary loses the right to demand $5,000. But he still has the right to demand the remaining $7,000. At the end of year two, the beneficiary loses the right to demand another $5,000. Consequently, in year three, the beneficiary may only demand $2,000. At the end of year

The demand right causes the beneficiary to be treated as the owner for income tax purposes. *See* PLR 201039010 (stating as much); *but cf*. Gorin, Steven B., *A Balanced Solution*, Trusts & Estates, 28 (May 2011) (pointing out that a withdrawal power that completely lapses, either immediately or over time, is inconsistent with the plain language of section 678(a)(2)).

The beneficiary then sells his or her business to the BGT in exchange for a promissory note in a similar manner as is done under the typical sale to an IDGT technique.[22] Because the beneficiary is treated as the owner of the trust for income tax purposes (maybe), the beneficiary does not recognize an income tax event upon the sale.

Nevertheless, the beneficiary has a general power of appointment over the trust to the extent his or her demand right has not lapsed. Over time, however, the withdrawal right, and consequent general power of appointment over the trust, lapses with no transfer tax consequence. Hopefully, the withdrawal right will have lapsed and the note will have been paid before the beneficiary dies. If so, the idea is that the business will have been transferred to the next generation with no income tax or transfer tax consequence. In the meantime, and even after the promissory note has been paid, the beneficiary retains a beneficial interest in the business as a beneficiary of the trust.

Conceptually, the sale to a BGT technique should work. One must be aware, however, that the technique's estate tax result has not been tested, not even in a private letter ruling. To date, all the private letter rulings about which the author is aware have focused on whether the beneficiary is treated as the owner for income tax purposes and have not taken any position on whether the goal of removing the asset from the estate works. *See, e.g*., PLRs 201039010 and 200949012. The author wonders whether this is too much of a good thing.

D. Grantor Retained Annuity Trusts

Unlike sales to IDGTs and BGTs, Congress has sanctioned the grantor retained annuity trust ("GRAT") technique for transferring wealth. *See* Code § 2702. A GRAT is an irrevocable trust to which the grantor makes a one time contribution and retains either an annuity or unitrust interest for a term of years. After the term has expired, the remaining assets, if any, pass to the remainder beneficiaries. The transfer to the trust necessarily triggers a gift tax consequence, based upon the present value of the expected remainder interest. The client may, however, customize the transfer tax cost of the initial transfer through adjustments of the annuity (or unitrust) and the length of the trust's term. Under current law, a GRAT may be adjusted such that the transfer cost approaches zero.[23]

The prevailing interest rate and the expected return on investment therefore have a significant impact on the viability of the technique in any given circumstance. The goal of any GRAT is to have an investment return greater than the interest rate used to calculate the present value of the remainder interest. The potential for success is aided by the fact that the GRAT's income is taxed to the grantor under the grantor trust rules, discussed above. If successful, the real value of the remainder interest will exceed the gift tax consequence.

1. <u>Applicable Interest Rate</u>

Code section 7520 governs valuation of the remainder interest of a GRAT. Code § 2702(a)(2)(B). In effect, the remainder interest is determined in the same manner as the value of any other interest for a term of years. Id. § 7520(a). The interest rate is 120% of the applicable federal rate for midterm obligations. *Id*. The 7520 rate for October 2011 is only 1.4%, a historical low.[24] *See* REV. RUL. 2011-22.

2. <u>GRAT Requirements</u>

Code section 2702 and its associated regulations have a handful of requirements for the GRAT to qualify. The most significant requirements are as follows:

- The annuity must be paid at least annually, Code § 2702(b)(1);
- The annuity must be either a fixed amount or a fraction of the trust's value determined annually, Regs. § 25.2702-3(b)(1)(ii);
- If the annuity amount increases over time, it may increase by no more than 20% of the previous year's annuity, *Id*. § 25.2702-3(e) Ex. 2;
- The right to receive the excess income from the trust, if any, may not be used to calculate the annuity amount, *Id*. § 25.2702-3(b)(1)(iii);

---

three, the beneficiary finally loses the right to demand the remainder of the initial gift to the trust. The effect is such that the beneficiary experienced no tax consequences at all over time.

[22] The BGT can also be used as a means of shifting economic opportunity. *See* Gorin, *A Balanced Solution*, Trusts & Estates, 28.

[23] Over the last several years, several bills have been introduced that would require a minimum term of 10 years and a minimum gift tax consequence of 10% of the value of the asset contributed to the GRAT. So far, these bills have only been proposals.

[24] Note that the section 7520 rate is 20% higher than the minimum rate required to avoid a deemed gift for the sale to an IDGT technique.

- The trust agreement must prohibit additional contributions, *Id*. § 25.2702-3(b)(5); and
- The trust agreement must prohibit prepayment of the annuitant's interest, *Id*. § 25.2702-3(d)(5).

3. Survival Requirement

The grantor must survive the GRAT's term for the remaining assets to be excluded from the grantor's estate. *See* Regs. § 20.2036-1(c)(2) (at least a portion of the trust remainder would be included). Fortunately, if the grantor does not survive the GRAT's term, all is not lost.

4. GSTT Consequences

GSTT exemption cannot be applied to the GRAT until it has terminated. *See* Regs. § 26.2632-1(c)(3)(ii) (GSTT exemption cannot be applied until the end of the estate tax inclusion period). The advisor should therefore give careful consideration to whether to design the trust to be a "GST trust" and whether the deemed allocation rules should be allowed to apply under Code section 2632(c).

5. Significant Options

- *Trustee* – Because the GRAT remainder will likely be included in the grantor's estate if he or she dies during its term, the grantor may serve as Trustee. Concerns under Code section 2036 become an issue after the annuity or unitrust period expires, however. In any event, the grantor can still retain the power to remove and replace the trustee as long as the grantor must choose a replacement who is not related to or subordinate to the grantor within the meaning of Code section 672(c). *See* REV. RUL. 95-58.
- *Formula Annuity* – The annuity amount may be defined as a fixed percentage of the fair market value of the initial contribution to the trust "as finally determined for federal tax purposes." Regs. § 25.2702-3(b)(1)(ii)(B). This option amounts to a sanctioned savings clause with respect to the valuation of the contributed asset.
- *Escalating Annuity Amounts* – The annuity also may be designed so that it increases over time, so long as the current year's annuity does not exceed 120% of the prior year's amount. Regs. § 25.2702-3(b)(1)(ii)(A). Such a provision can allow the assets within the GRAT to appreciate or accumulate income faster at the beginning, or to allow an initial period with a smaller cash flow requirement.
- *Satisfaction of Annuity in Kind* – The GRAT, especially one that is designed to have a minimum gift tax consequence, certainly might not have sufficient income to satisfy an annuity. The GRAT should allow for satisfaction in kind. Note that the GRAT may not issue a note to the grantor in satisfaction of the annuity amount. Regs. § 25.2702-3(b)(1)(i).
- *Rolling GRATs* – Especially when the GRAT is expected to be forced to satisfy the annuity in kind, the drafter should consider the use of rolling GRATs. The technique simply rolls the distribution of the in kind assets into a new GRAT with similar terms. The only difference will be the section 7520 rate in effect at the time the new GRAT is funded. Several planners use short term GRATs (2 years) in combination with the rolling concept to lower the risk that the grantor dies before a longer term GRAT will terminate. Short term GRATs also may lower the risk of volatility.
- *Allow the Grantor to Re-Purchase or Substitute GRAT Assets* – The existence of a grantor retained right to substitute assets in the GRAT likely does not disqualify the GRAT. *See* PLR 200846001. The grantor then will have an opportunity to substitute low basis assets within the GRAT for cash or even lock in gains and hedge against the risk of loss in the future.
- *Contribute Cash with Illiquid Assets* – The cash can provide a cushion for paying the annuity while the illiquid asset is given time to develop a cash flow.

E. Preferred Partnerships

A preferred partnership ("PP") is another technique designed to freeze the value of an owner's interest in an asset that has further income or growth potential. There are two classes in a PP, which may be either a limited partnership or a limited liability company, that are separated based upon the economic rights in the company. *See* Angkatavanich, N. Todd & Edward A. Vergara, *Preferred Partnership Freezes*, Trusts & Estates, 20 (May 2011). PPs are structured to comply with Code section 2701. Typically, the older generation will contribute assets to the PP in exchange for preferred interests that pay a fixed, cumulative, annual preferred return. *Id*. The lower generation will contribute assets in exchange for interests that have all other economic interests associated with the entity. *Id*. Typically, the older generation will have a portion of the remainder interest, as well. *Id*.

The author admits little familiarity with this technique, which appears to be little used, and learned of it through the referenced article. Advisors should consult Code section 2701 and REV. RUL. 83-120, as well as other sources before embarking on this type of estate freeze technique.

F. Comparison of Various Estate Freeze Techniques

With all the options available to the estate planner and his or her clients, it can be difficult to choose the right technique. Generally speaking, the most effective strategy probably is to act now rather than later because assets that have produced wealth tend to appreciate over time. Acting now also provides the lower generation with the opportunity to continue generating wealth with the asset without the fear that it might be subject to an onerous estate tax in the parent's estate.

But the real economic effect of one approach over another is not inherently obvious. Attached as Exhibit A is a series of spreadsheets that attempt to quantify the difference between some of the various techniques over a ten year period. The techniques compared are: (a) keeping the asset until death, (b) giving the asset outright, (c) giving the asset to a grantor trust, (d) selling the asset to an IDGT, and (e) giving the asset to a GRAT. The author has made one basic assumption that necessarily deviates from the real world: interest rates and returns remain constant over time. One also might point out that the assumed rate of income and growth (7.0% and 3.0%, respectively) are a bit high for most assets. The required statutory rates used are those for October 2011 as found in REV. RUL. 2011-22. While those rates are real, use of the all time lowest rates skews the results somewhat, and has the effect of increasing the marginal differences between the various methods.

VI. SHIFTING FUTURE OPPORTUNITIES

This section may be pointing out the obvious. But the author has found that many clients have not really considered the possibility because they have been engrossed in and in control of their business for so long. At some point, a successful entrepreneur must decide when enough is enough. If he or she pursues every opportunity for making money that presents itself, the client is merely adding to his or her business succession and taxation problem (if the pursuit is successful). On the other hand, if the client steers the opportunity to a child and the child is successful, the client will have effectively transferred wealth with no transfer tax consequence (and virtually no legal fees).

Sophisticated family limited liability company and limited partnership planning also requires that the various family members contribute value to the family holding company in exchange for their respective ownership interests. The financial contribution is required to meet the economic substance test as defined by Code § 7701(o) and addressed in more detail above. The prior shifting of business opportunities allows the family member to generate his or her own wealth for later contribution to the family holding company.

VII. TRANSFERS AT DEATH

A. Surviving Spouses

Special consideration must be given to the client's basic estate planning documents when a family business is involved. Even if the plan is for the business owner to divest him or herself from the business and enjoy life on the cash flow generated by the divestment, the best laid plans often go awry. Regardless, the client may not have used all of his or her remaining estate tax or generation-skipping transfer tax exemptions.

1. <u>Basic Estate Plan</u>

The client must have at least the basic tax planned will or trust in place. The typical estate plan designed to address the estate tax will send as much of the estate of the first spouse to die (the "deceased spouse") as possible to a Bypass or Credit Shelter Trust for the surviving spouse's benefit. The limit of the value of property that may go to the Bypass Trust is the deceased spouse's remaining estate tax exemption less debts, taxes and administration expenses. The amount of available estate tax exemption may have been significantly reduced during the decedent's life depending on how far along the business succession plan had proceeded.

The excess either will pass to the surviving spouse, outright, or to a Marital Deduction or "QTIP" Trust, again for the surviving spouse's benefit. At the second death, the surviving spouse's estate and the remainder of the Marital Trust will be added to determine estate tax liability. After payment of estate taxes, the remainder of the surviving spouse's estate and the Bypass and Marital Trusts will go to the couple's children or other chosen beneficiaries.

In the context of a Will, the typical plan looks like the diagram found on Exhibit B. Similarly and in the context of a single Revocable Trust for a married couple, the typical plan looks like the diagram found on Exhibit C.

It may be that the surviving spouse has had no involvement in the company, but will rely on income from the company to maintain him or her in the standard of living to which the surviving spouse has become accustomed. In such a situation, special attention must be directed towards the drafting of the basic estate plan to address several factors, including but not limited to:

- the identity of the successor trustee (or the appointment of a special trustee to vote the ownership interest in the family company);
- the appointment of trust protectors, if any, (with or without fiduciary duties towards the surviving spouse) and the scope of the trust protector's powers;

- the standards for distribution of principal, if any;
- whether to establish a separate trust to hold the family business interests from the rest of the family wealth;
- the scope of any testamentary powers of appointment granted to the surviving spouse;
- adjustment of the prudent investor rule to account for the inherently risky investment nature of a family business;
- contracts for guaranteed payments or distributions from the family business to lessen the threat of minority oppression, especially in the context of a second marriage; and
- coordination of buy-sell and transfer restriction provisions with the basic estate plan.

2. <u>The Portability Fallacy</u>

The Tax Relief Act of 2010 introduced the concept of the "deceased spousal unused exclusion amount". *See* Code § 2010(c)(4). The pundits in the estate planning arena refer to the concept as portability of the estate tax exemption.

Portability allows the surviving spouse to utilize any estate tax exemption the deceased spouse did not use. For example, assume a husband with a taxable estate died with a simple will that gave everything to his wife. Even though the estate was taxable and required an estate tax return, the deceased husband's estate did not utilize any of his estate tax exemption to avoid estate taxes. Rather, the entire testamentary gift to the wife qualified for the marital deduction.

Upon the wife's subsequent death, she likely will have a taxable estate composed of her own estate plus the assets she inherited from her former husband. Under prior law, her estate could use only the exemption she had left. Her husband's exemption was effectively wasted. With portability, however, the wife potentially would be able to use the husband's estate tax exemption to reduce or even eliminate estate tax liability.

While portability of unused estate tax exemption between spouses certainly will help those who foolishly fail to establish a basic estate plan, portability leaves much to be desired and is not a panacea.

First, the deceased spouse's executor must elect portability on the decedent's estate tax return. Code § 2010(c)(5)(A). Estate tax returns are not simple affairs and certainly cost money to prepare correctly. There does not appear to be any way to force the executor to make the election for the benefit of the spouse. In a second spouse situation, for example, the executor may have no incentive to go to the trouble of making the election.

Second, the surviving spouse can use only her last husband's remaining exemption amount. *See* Code § 2010(c)(4)(B)(i) (availability is limited to the "last … deceased spouse" of the decedent). As a result, the surviving spouse may be effectively prohibited from remarrying simply to avoid estate taxation. A Bypass trust would avoid this problem

Third, the exemption amount that is portable is a fixed sum and is not adjusted for inflation. Code § 2010(c)(4). If the spouse lives for a long time the values inherited might increase significantly and no longer be covered by the portability exemption. In contrast, had the assets been used to fund a Bypass Trust, the assets would not be subject to taxation on the surviving spouse's death regardless of value.

Finally, the portability exemption provides the deceased spouse with no ability to fix the manner in which the assets are inherited or to whom they will pass on the surviving spouse's death. It also fails to provide the surviving spouse (and remainder beneficiaries) with any creditor protection. Both of these issues can be addressed through adoption of a Bypass Trust.

3. <u>Reverse QTIP Election</u>

Even if the client has utilized all of his or her estate tax exemption by making lifetime taxable gifts, the client may not have used a material portion of his or her exemption from the generation-skipping transfer tax ("GSTT"). A client can preserve unused exemption from the GSTT by establishing a QTIP trust for his or her surviving spouse. If there is unused exemption, the executor may elect, under Code § 2652(a)(3), to apply the remaining GSTT exemption to a portion or all of the QTIP trust, thus preserving it. The surviving spouse's executor then would be able to apply any of her remaining GSTT exemption to the remainder of the QTIP trust or other property in her estate.

4. <u>Marital Property Agreement</u>

Under Code § 1014(b)(6), community property receives special treatment. Both halves of community property receive a step-up in basis to the date of death value regardless of which spouse dies first. Separate property, in stark contrast, only receives a step-up in basis upon the death of the spouse owning the property. *Id*. If the family business is the separate property of one of the spouses, the married couple should consider entering a written agreement to hold the property as community property under NMSA § 40-2-4, *et seq.* to take advantage of the potential for step-up. *See* NMSA § 40-2-8 (providing that married persons may alter the legal nature of their property by written agreement).

B. Descendants

1. Generation-Skipping Trusts

In many successful families, the children of the business' founder also will have substantial wealth. An outright inheritance may simply increase a child's preexisting estate tax problem. The creation of a testamentary generation-skipping trust can ameliorate and possibly eliminate the problem of estate taxes for the second generation, if the parent has remaining exemption from the GSTT. The technique also may dilute a child's control, as an individual, of the family business to less than majority so that a valuation discount might be appropriate. Otherwise, the child might have inherited control of the company and his or her estate might actually be subject to a valuation premium.

2. Spendthrift Trusts

Protecting the business from outsiders, especially creditors of the various family members is usually of high importance. One may insulate ownership and control of a family business from the creditors of the family by establishing spendthrift trusts to hold the interest in the company.

Under New Mexico law, a beneficiary's creditors may seek a court order to attach both present and future distributions from the trust if it does not contain a spendthrift provision. NMSA §§ 46A-5-501, 46A-5-503(C). But if drafted correctly, a valid spendthrift provision will prevent most of the beneficiary's creditors from attaching any interest in or distribution from the trust before the beneficiary actually receives the distribution. *Id.* § 46A-5-502(C). Note that the legal effect of a spendthrift provision is mandatory and cannot be altered by the trust agreement. *Id.* § 46A-1-105(B)(5).

To be valid, the spendthrift provision must prohibit the beneficiary from making both involuntary and voluntary transfers of his or her interests in the trust. NMSA § 46A-5-502(A). It is exceedingly easy to meet this requirement. The trust must only provide that the beneficiary's interests are subject to a "spendthrift trust", or words of similar import. *Id.* § 46A-5-502(B).

There are a handful of exceptions to the creditor protection afforded by a spendthrift trust. There is no protection against:

- a beneficiary's child, spouse or former spouse who has a judgment or court order against the beneficiary for support or maintenance;
- a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust; and
- a claim of the State of New Mexico or the United States to the extent a statute or federal law so provides.

NMSA § 46A-5-503(B).

A discretionary trust also provides the beneficiary with creditor protection, regardless of whether the trust contains a spendthrift provision. NMSA § 46A-5-504(B). A discretionary trust is one in which the Trustee has the discretion to make a distribution. In other words, the distribution is not mandatory. The creditor protection applies in most instances even if the discretion is expressed in the form of a standard of distribution or the Trustee has abused its discretion. *Id.*

New Mexico law also specifically protects the Trustee who has discretion to make distributions to himself or herself as a beneficiary. If the Trustee/beneficiary's discretion is limited by an ascertainable standard, the beneficiary's creditors may not compel a distribution simply because the beneficiary also is the Trustee who is exercising discretion. NMSA § 46A-5-504(E). Accordingly, a child may be the Trustee without fear of losing creditor protection, assuming the trust is governed by New Mexico law.

Discretionary trusts have a single exception to creditor protection. A child, spouse or former spouse of the beneficiary may maintain an action for attachment related to past due support, but only to the extent the Trustee has either violated the standards for distribution or has abused its discretion. NMSA § 46A-5-504(C).

In the end, to provide maximum creditor protection, the trust should be both a spendthrift trust and a discretionary trust. To the extent the Trustee has discretion to make or withhold distributions, the only creditors who would have the power to compel a distribution would be child support or spousal maintenance claimants. *Compare* NM STAT. §§ 46A-5-503(B) and 46A-5-504(C).

VIII. APPRAISALS

Appraisals are an integral part of all business succession plans. They are necessary to establish the fair market value of the property being transferred. The author has been amazed at the cavalier attitude some practitioners have regarding the necessity and the preparation of the appraisal.

A. Appraiser and Appraisal Standards

1. Appraiser Standards

A detailed discussion of the standards for appraisers and appraisal reports is beyond the scope of this paper. Attorneys advising business owners in the context of business succession should, nevertheless, keep in mind several basic issues when seeking out professional appraisers and reviewing draft appraisals before acceptance.

The IRS Regulations set the standards for adequate disclosure in the context of triggering the statute of limitations for gift tax returns. *See* Regs. § 301.6501(c)-1(f). Under section 301.6501(c)-1(f) and at a minimum, the appraiser must satisfy the following:

- The appraiser is an individual holding himself or herself out to the public as an appraiser, or performs appraisals on a regular basis;
- The appraiser is qualified to make appraisals of the type of property at issue by virtue of the appraiser's background, experience, education and memberships in professional appraisal associations, if any; and
- The appraiser is not a family member of the donor's family or a person employed by the donor's family.

Regs. § 301.6501(c)-1(f)(3)(i). One issue raised by these standards is whether the family's CPA firm might be the right choice for preparing the valuation of the decedent's closely held business. While the regulations do not apply, technically, to disqualify the family's CPA firm to act as an appraiser, a long time relationship does raise questions as to impartiality.

The numerous and difficult to determine factors required to be considered in valuing small businesses also, by necessity, require a certain level of competency and experience for appraisers as well. *See Id*. §§ 20.2031-2(f), 20.2031-3 (the factors to be considered are discussed below). An attorney's failure to ensure that competent appraisers are hired may produce disastrous results.

2. Appraisal Standards

To be considered adequate, the appraisal itself must contain the following information (again, in the context of adequate disclosure for gift tax returns, which should provide guidance for estate tax returns):

- The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal;
- A description of the property;
- A description of the appraisal process employed;
- A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions;
- The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value;
- The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions;
- The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred; and
- The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

Regs. § 301.6501(c)-1(f)(3)(ii). Revenue Procedure 66-49, which was decided in the context of the income tax, provides further guidance as to the type of information that any appraisal should include. The procedure requires:

- A summary of the appraiser's qualifications;
- A statement of the value including the appraiser's definition of value;
- The bases for the opinion, including a description of any restrictions regarding the use or disposition of the property;
- The valuation date; and
- The appraiser's signature and date of the appraisal.

REV. PROC. 66-49.

Care should be taken to ensure the appraiser uses the correct definition of fair market value, which can change, depending on the context. For purposes of estate tax returns, "fair market value" means, as of the date of death, "the price at which the 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". Regs. § 20.2031-1(b). All appraisals should indicate use of this definition of fair market value.

Clearly, any appraisal of an item should address the issues raised in the regulations for that type of item, if any. The general principles for valuation set forth in section 20.2031-1(b) of the regulations, for example, set forth examples of how to return values of certain items, like automobiles, livestock and crops. They also typically require that values be returned on an itemized basis, rather than for lots. Regs. § 20.2031-1(b).

Also, the executor must take several factors into consideration in valuing stock and other business interests for which there is no ready market. Regs. §§ 20.2031-2(f)(1), (2) (the other relevant factors include the company's net worth, prospective earning power, good will, economic outlook, management, and non-operating assets); 20.2031-3 (same). Revenue Ruling 59-60 also must be consulted in connection with any valuation of a small business. It sets forth the appropriate methods for valuing a company, the specific factors for consideration, and the weight to accord to various factors. REV. RUL. 59-60. Any appraisal that ignores these requirements (or fails to include them because of oversight) will be subject to attack. Because it is so important, a copy of the ruling is attached as Exhibit D.

Exhibit A

Client Keeps Asset until Death

Year	Value at Beginning of Year	Income to Client (7%)	Client's Income Tax	Growth (3%)	Net Value after Taxes at End of Year	Estate Tax Paid from the Asset if Client Dies at End of Year	Net to Beneficiary from the Asset	Value of Exchanged Asset	Gross Estate Available to Other Beneficiaries at Beginning of Year	Interest Income of 3% on Estate Available for Other Beneficiaries	Client's Income Taxes for Other Assets	Gross Estate Available to Other Beneficiaries at End of Year	Estate Tax Paid from Other Assets ($5,000,000 exemption remaining)	Net Estate for Other Beneficiaries	Net Estate to all Beneficiaries	Percentage Difference from Gift to IDGT	Percentage Difference from Sale to IDGT
1	1,000,000	70,000	24,500	30,000	1,075,500	376,425	699,075	N/A	10,000,000	300,000	105,000	10,170,500	1,809,675	8,360,825	9,059,900	-0.56%	-0.52%
2	1,075,500	75,285	26,350	32,265	1,156,700	404,845	751,855	N/A	10,170,500	305,115	106,790	10,342,475	1,869,866	8,472,609	9,224,464	-1.17%	-1.24%
3	1,156,700	80,969	28,339	34,701	1,244,031	435,411	808,620	N/A	10,342,475	310,274	108,596	10,515,814	1,930,535	8,585,279	9,393,899	-1.82%	-2.02%
4	1,244,031	87,082	30,479	37,321	1,337,955	468,284	869,671	N/A	10,515,814	315,474	110,416	10,690,394	1,991,638	8,698,756	9,568,427	-2.53%	-2.86%
5	1,337,955	93,657	32,780	40,139	1,438,971	503,640	935,331	N/A	10,690,394	320,712	112,249	10,866,076	2,053,127	8,812,950	9,748,281	-3.29%	-3.76%
6	1,438,971	100,728	35,255	43,169	1,547,613	541,665	1,005,949	N/A	10,866,076	325,982	114,094	11,042,710	2,114,949	8,927,762	9,933,710	-4.11%	-4.72%
7	1,547,613	108,333	37,917	46,428	1,664,458	582,560	1,081,898	N/A	11,042,710	331,281	115,948	11,220,127	2,177,044	9,043,082	10,124,980	-4.99%	-5.75%
8	1,664,458	116,512	40,779	49,934	1,790,125	626,544	1,163,581	N/A	11,220,127	336,604	117,811	11,398,140	2,239,349	9,158,791	10,322,372	-5.95%	-6.86%
9	1,790,125	125,309	43,858	53,704	1,925,279	673,848	1,251,432	N/A	11,398,140	341,944	119,680	11,576,545	2,301,791	9,274,755	10,526,186	-6.98%	-8.05%
10	1,925,279	134,770	47,169	57,758	2,070,638	724,723	1,345,915	N/A	11,576,545	347,296	121,554	11,755,119	2,364,292	9,390,827	10,736,742	-8.09%	-8.70%

Client Gives Asset Outright

Year	Value at Beginning of Year	Income to Beneficiary (7%)	Bene.'s Income Tax	Growth (3%)	Net Value after Taxes at End of Year	Transfer Tax	Net to Beneficiary from the Asset	Value of Exchanged Asset	Gross Estate Available to Other Beneficiaries at Beginning of Year	Interest Income of 3% on Estate Available for Other Beneficiaries	Client's Income Taxes for Other Assets	Gross Estate Available to Other Beneficiaries at End of Year	Estate Tax Paid from Other Assets ($4,000,000 exemption remaining)	Net Estate for Other Beneficiaries	Net Estate to all Beneficiaries	Percentage Difference from Keeping Asset	Percentage Difference from Gift to IDGT
1	1,000,000	70,000	24,500	30,000	1,075,500	N/A	1,075,500	N/A	10,000,000	300,000	105,000	10,195,000	2,168,250	8,026,750	9,102,250	0.47%	-0.09%
2	1,075,500	75,285	26,350	32,265	1,156,700	N/A	1,156,700	N/A	10,195,000	305,850	107,048	10,393,803	2,237,831	8,155,972	9,312,672	0.95%	-0.21%
3	1,156,700	80,969	28,339	34,701	1,244,031	N/A	1,244,031	N/A	10,393,803	311,814	109,135	10,596,482	2,308,769	8,287,713	9,531,744	1.45%	-0.35%
4	1,244,031	87,082	30,479	37,321	1,337,955	N/A	1,337,955	N/A	10,596,482	317,894	111,263	10,803,113	2,381,090	8,422,023	9,759,979	1.96%	-0.51%
5	1,337,955	93,657	32,780	40,139	1,438,971	N/A	1,438,971	N/A	10,803,113	324,093	113,433	11,013,774	2,454,821	8,558,953	9,997,924	2.50%	-0.71%
6	1,438,971	100,728	35,255	43,169	1,547,613	N/A	1,547,613	N/A	11,013,774	330,413	115,645	11,228,542	2,529,990	8,698,553	10,246,166	3.05%	-0.93%
7	1,547,613	108,333	37,917	46,428	1,664,458	N/A	1,664,458	N/A	11,228,542	336,856	117,900	11,447,499	2,606,625	8,840,874	10,505,333	3.62%	-1.19%
8	1,664,458	116,512	40,779	49,934	1,790,125	N/A	1,790,125	N/A	11,447,499	343,425	120,199	11,670,725	2,684,754	8,985,971	10,776,096	4.21%	-1.49%
9	1,790,125	125,309	43,858	53,704	1,925,279	N/A	1,925,279	N/A	11,670,725	350,122	122,543	11,898,304	2,764,406	9,133,898	11,059,177	4.82%	-1.82%
10	1,925,279	134,770	47,169	57,758	2,070,638	N/A	2,070,638	N/A	11,898,304	356,949	124,932	12,130,321	2,845,612	9,284,709	11,355,347	5.45%	-2.20%

Client Gives Asset to IDGT

Year	Value at Beginning of Year	Income to Beneficiary (7%)	Client's Income Tax	Growth (3%)	Net Value at End of Year	Transfer Tax	Net to Beneficiary	Value of Exchanged Asset	Gross Estate Available to Other Beneficiaries at Beginning of Year	Interest Income of 3% on Estate Available for Other Beneficiaries	Client's Income Taxes for Other Assets	Gross Estate Available to Other Beneficiaries at End of Year	Estate Tax Paid from Other Assets ($4,000,000 exemption remaining)	Net Estate for Other Beneficiaries	Net Estate to all Beneficiaries	Percentage Difference from Keeping Asset	Percentage Difference from Sale to IDGT
1	1,000,000	70,000	24,500	30,000	1,100,000	N/A	1,100,000	N/A	10,000,000	300,000	105,000	10,170,500	2,159,675	8,010,825	9,110,825	0.56%	0.05%
2	1,100,000	77,000	26,950	33,000	1,210,000	N/A	1,210,000	N/A	10,170,500	305,115	106,790	10,341,875	2,219,656	8,122,219	9,332,219	1.15%	-0.08%
3	1,210,000	84,700	29,645	36,300	1,331,000	N/A	1,331,000	N/A	10,341,875	310,256	108,590	10,513,896	2,279,864	8,234,033	9,565,033	1.79%	-0.20%
4	1,331,000	93,170	32,610	39,930	1,464,100	N/A	1,464,100	N/A	10,513,896	315,417	110,396	10,686,308	2,340,208	8,346,100	9,810,200	2.46%	-0.33%
5	1,464,100	102,487	35,870	43,923	1,610,510	N/A	1,610,510	N/A	10,686,308	320,589	112,206	10,858,820	2,400,587	8,458,233	10,068,743	3.18%	-0.46%
6	1,610,510	112,736	39,457	48,315	1,771,561	N/A	1,771,561	N/A	10,858,820	325,765	114,018	11,031,110	2,460,888	8,570,221	10,341,782	3.95%	-0.59%
7	1,771,561	124,009	43,403	53,147	1,948,717	N/A	1,948,717	N/A	11,031,110	330,933	115,827	11,202,813	2,520,985	8,681,829	10,630,546	4.76%	-0.72%
8	1,948,717	136,410	47,744	58,462	2,143,589	N/A	2,143,589	N/A	11,202,813	336,084	117,630	11,373,525	2,580,734	8,792,791	10,936,380	5.61%	-0.86%
9	2,143,589	150,051	52,518	64,308	2,357,948	N/A	2,357,948	N/A	11,373,525	341,206	119,422	11,542,790	2,639,977	8,902,814	11,260,761	6.52%	-1.00%
10	2,357,948	165,056	57,770	70,738	2,593,742	N/A	2,593,742	N/A	11,542,790	346,284	121,199	11,710,105	2,698,537	9,011,568	11,605,311	7.48%	-0.57%

Client Sells Asset to IDGT

Year	Gross Value at Beginning of Year	Income to Beneficiary (7%)	Client's Income Tax	Growth (3%)	Net Value after Payment of Interest (or Note) at End of Year	Transfer Taxes	Net to Beneficiary	Value of Exchanged Asset plus Income (current mid-term AFR - 1.19%)	Gross Estate Available to Other Beneficiaries at Beginning of Year	Interest Income of 3% on Estate Available for Other Beneficiaries	Client's Income Taxes for Other Assets	Gross Estate Available to Other Beneficiaries at End of Year	Estate Tax Paid from Other Assets ($5,000,000 exemption remaining)	Net Estate for Other Beneficiaries	Net Estate to all Beneficiaries	Percentage Difference from Keeping Asset	Percentage Difference from Gift to IDGT
1	1,000,000	70,000	24,500	30,000	88,100	N/A	88,100	1,011,900	10,000,000	300,000	105,000	11,182,400	2,163,840	9,018,560	9,106,660	0.51%	-0.05%
2	1,088,100	76,167	26,658	32,643	185,010	N/A	185,010	1,011,900	10,206,900	306,207	107,172	11,391,176	2,236,912	9,154,264	9,339,274	1.23%	0.08%
3	1,185,010	82,951	29,033	35,550	291,611	N/A	291,611	1,011,900	10,417,835	312,535	109,387	11,603,850	2,311,347	9,292,502	9,584,113	1.98%	0.20%
4	1,291,611	90,413	31,644	38,748	408,872	N/A	408,872	1,011,900	10,632,882	318,986	111,645	11,820,479	2,387,168	9,433,311	9,842,183	2.78%	0.32%
5	1,408,872	98,621	34,517	42,266	537,859	N/A	537,859	1,011,900	10,852,124	325,564	113,947	12,041,123	2,464,393	9,576,730	10,114,589	3.62%	0.45%
6	1,537,859	107,650	37,678	46,136	679,745	N/A	679,745	1,011,900	11,075,640	332,269	116,294	12,265,837	2,543,043	9,722,794	10,402,540	4.51%	0.58%
7	1,679,745	117,582	41,154	50,392	835,820	N/A	835,820	1,011,900	11,303,515	339,105	118,687	12,494,680	2,623,138	9,871,542	10,707,362	5.44%	0.72%
8	1,835,820	128,507	44,978	55,075	1,007,502	N/A	1,007,502	1,011,900	11,535,833	346,075	121,126	12,727,705	2,704,697	10,023,008	11,030,510	6.42%	0.85%
9	2,007,502	140,525	49,184	60,225	1,196,352	N/A	1,196,352	1,011,900	11,772,682	353,180	123,613	12,964,966	2,787,738	10,177,228	11,373,580	7.45%	0.99%
10	1,196,352	83,745	29,311	35,891	1,315,987	N/A	1,315,987	0	13,014,150	390,424	136,649	13,238,615	2,883,515	10,355,100	11,671,087	8.01%	0.56%

Client Gives Asset to GRAT (assuming client survives term)

Year	Gross Value at Beginning of Year	Income to Trust (7%)	Client's Income Tax	Growth (3%)	Value at End of Year after payment of $100k Annuity	Transfer Taxes	Net to Remainder Beneficiary	Annuity	Gross Estate Available to Other Beneficiaries at Beginning of Year	Interest Income of 3% on Estate Available for Other Beneficiaries	Client's Income Taxes for Other Assets	Gross Estate at End of Year	Estate Tax Paid from Gross Estate ($4,920,000 exemption remaining)	Net Estate for Other Beneficiaries	Net Estate to all Beneficiaries	Percentage Difference from Keeping Asset	Percentage Difference from Outright Gift
1	1,000,000	70,000	24,500	30,000	1,000,000	N/A	N/A	100,000	10,000,000	300,000	105,000	10,270,500	N/A	N/A	N/A	N/A	N/A
2	1,000,000	70,000	24,500	30,000	1,000,000	N/A	N/A	100,000	10,270,500	308,115	107,840	10,546,275	N/A	N/A	N/A	N/A	N/A
3	1,000,000	70,000	24,500	30,000	1,000,000	N/A	N/A	100,000	10,546,275	316,388	110,736	10,827,427	N/A	N/A	N/A	N/A	N/A
4	1,000,000	70,000	24,500	30,000	1,000,000	N/A	N/A	100,000	10,827,427	324,823	113,688	11,114,062	N/A	N/A	N/A	N/A	N/A
5	1,000,000	70,000	24,500	30,000	1,000,000	N/A	N/A	100,000	11,114,062	333,422	116,698	11,406,286	N/A	N/A	N/A	N/A	N/A
6	1,000,000	70,000	24,500	30,000	1,000,000	N/A	N/A	100,000	11,406,286	342,189	119,766	11,704,209	N/A	N/A	N/A	N/A	N/A
7	1,000,000	70,000	24,500	30,000	1,000,000	N/A	N/A	100,000	11,704,209	351,126	122,894	12,007,941	N/A	N/A	N/A	N/A	N/A
8	1,000,000	70,000	24,500	30,000	1,000,000	N/A	N/A	100,000	12,007,941	360,238	126,083	12,317,596	N/A	N/A	N/A	N/A	N/A
9	1,000,000	70,000	24,500	30,000	1,000,000	N/A	N/A	100,000	12,317,596	369,528	129,335	12,633,289	N/A	N/A	N/A	N/A	N/A
10	1,000,000	70,000	24,500	30,000	1,000,000	N/A	1,000,000	100,000	12,633,289	378,999	132,650	12,955,138	2,847,298	10,107,840	11,107,840	3.34%	-2.23%

EXHIBIT B
TYPICAL REVOCABLE TRUST TAX PLAN

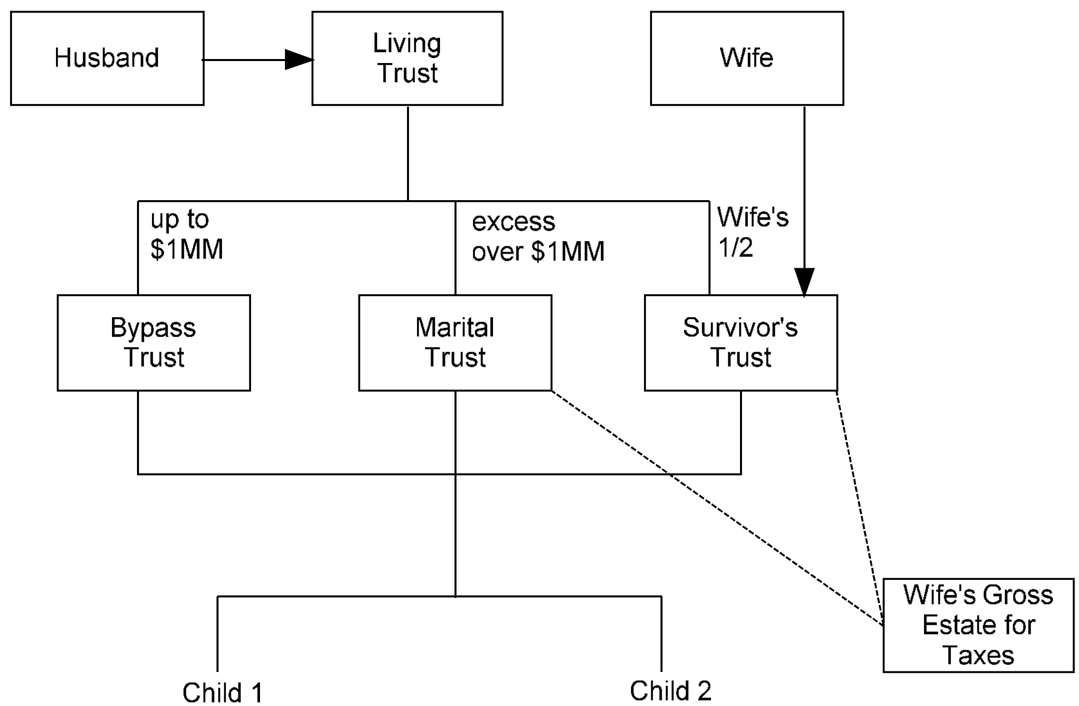
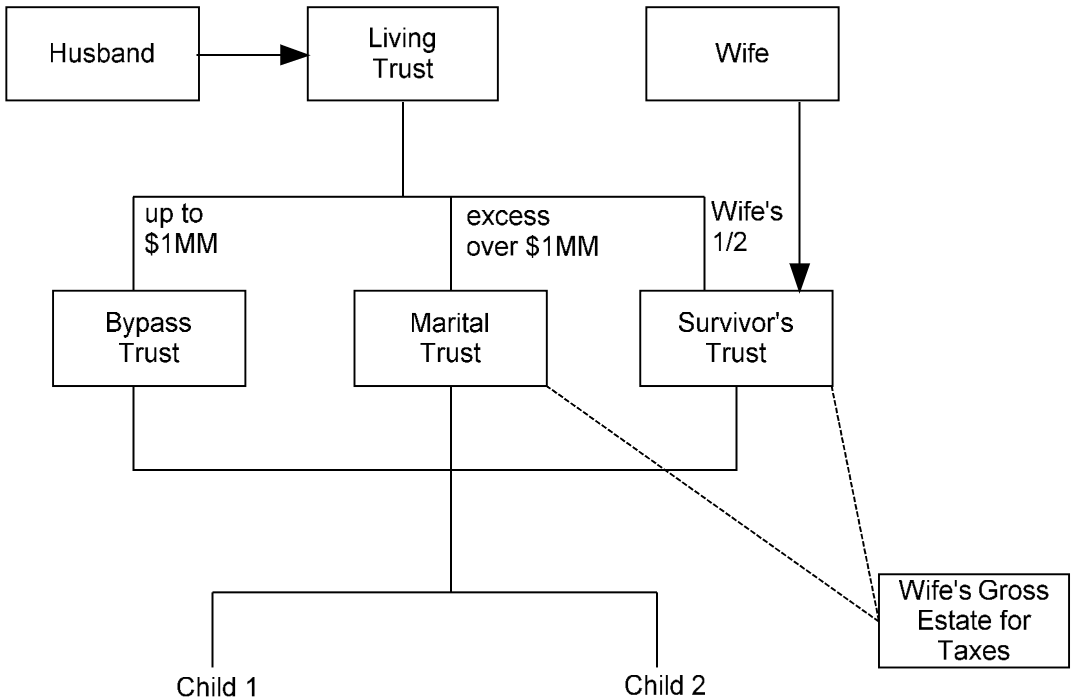


EXHIBIT C
TYPICAL REVOCABLE TRUST TAX PLAN



<u>Exhibit D</u>

Revenue Ruling 59-60

January 1959

In valuing the stock of closely held corporations, or the stock of corporations where market quotations are not available, all other available financial data, as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes. No general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock. However, the general approach, methods, and factors which must be considered in valuing such securities are outlined.

Revenue Ruling 54-77, C.B. 1954-1, 187, superseded.

SECTION 1. PURPOSE.

The purpose of this Revenue Ruling 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 tax and gift tax purposes. The methods discussed herein will apply likewise to the valuation of corporate stocks on which market quotations are either unavailable or are of such scarcity that they do not reflect the fair market value.

SEC. 2. BACKGROUND AND DEFINITIONS.

.01 All valuations must be made in accordance with the applicable provisions of the Internal Revenue Code of 1954 and the Federal Estate Tax and Gift Tax Regulations. Sections 2031 (a), 2032 and 2512 (a) of the 1954 Code (sections 811 and 1005 of the 1939 Code) require that the property to be included in the gross estate, or made the subject of a gift, shall be taxed on the basis of the value of the property at the time of death of the decedent, the alternate date if so elected, or the date of gift.

.02 Section 20.2031-1 (b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations (section 86.19 of Gift Tax Regulations 108) define fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

.03 Closely held corporations are those corporations the shares of which are owned by a relatively limited number of stockholders. Often the entire stock issue is held by one family. The result of this situation is that little, if any, trading in the shares takes place. There is, therefore, no established market for the stock and such sales as occur at irregular intervals seldom reflect all of the elements of a representative transaction as defined by the term "fair market value."

SEC. 3. APPROACH TO VALUATION.

.01 A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the-relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

.02 The fair market value of specific shares of stock will vary as general economic conditions change from "normal" to "boom" or "depression," that is according to the degree of optimism or pessimism with which the investing public regards the future at the required date of appraisal. Uncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future. The value of shares of stock of a company with very uncertain future prospects is highly speculative. The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting value.

.03 Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal. As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which the stocks of companies engaged in the same or a similar line of business are selling in a free and open market.

SEC. 4. FACTORS TO CONSIDER.

.01 It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive are fundamental and require careful analysis in each case:

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock and the-financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) Sales of the stock and the size of the block of stock to be valued.

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

.02 The following is a brief discussion of each of the foregoing factors:

(a) The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business. For an enterprise which changed its form of organization but carried on the same or closely similar operations of its predecessor, the history of the former enterprise should be considered. The detail to be considered should increase with approach to the required date of appraisal, since recent events are of greatest help in predicting the future; but a study of gross and net income, and of dividends covering a long prior period, is highly desirable. The history to be studied should include, but need not be limited to, the nature of the business, its products or services, its operating and investment assets, capital structure, plant facilities, sales records and management, all of which should be considered as of the date of the appraisal, with due regard for recent significant changes. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy.

(b) A sound appraisal of a closely held stock must consider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied. It is important to know that the company is more or less successful than its competitors in the same industry, or that it is maintaining a stable position with respect to competitors. Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries. Prospective competition which has not been a factor in prior years should be given careful attention. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition. The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in the markets for commodities and for securities. The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

(c) Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules. These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2) gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth. Consideration also should be given to any assets not essential to the operation of the business, such as investments in securities, real estate, etc. In general, such nonoperating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true. In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly. Comparison of the company's balance sheets over several years may reveal, among other facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and details as to recapitalizations and other changes in the capital structure of the corporation. If the corporation has more than one class of stock outstanding, the charter or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues including: (1) voting powers, (2) preference as to dividends, and (3) preference as to assets in the event of liquidation.

(d) Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years. Such statements should show (1) gross income by principal items; (2) principal deductions from gross income including major prior items of operating expenses, interest and other expense on each item of long-term debt, depreciation and depletion if such deductions are made, officers' salaries, in total if they appear to be reasonable or in detail if they seem to be excessive, contributions (whether or not deductible for tax purposes) that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess profits taxes; (3) net income available for dividends; (4) rates and amounts of dividends paid on each class of stock; (5) remaining amount carried to surplus; and (6) adjustments to, and reconciliation with, surplus as stated on the balance sheet. With profit and loss statements of this character available, the appraiser should be able to separate recurrent from nonrecurrent items of income and expense, to distinguish between operating income and investment income, and to ascertain whether or not any line of business in which the company is engaged is operated consistently at a loss and might be abandoned with benefit to the company. The percentage of earnings retained for business expansion should be noted when dividend-paying capacity is considered. Potential future income is a major factor in many valuations of closely-held stocks, and all information concerning past income which will be helpful in predicting the future should be secured. Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power. It will be helpful, in judging risk and the extent to which a business is a marginal operator, to consider deductions from income and net income in terms of percentage of sales. Major categories of cost and expense to be so analyzed include the consumption of raw materials and supplies in the case of manufacturers, processors and fabricators; the cost of purchased merchandise in the case of merchants; utility services; insurance; taxes; depletion or depreciation; and interest.

(e) Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition. Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity. Specifically, the dividends paid by a closely held family company may be measured by the income needs of the stockholders or by their desire to avoid taxes on dividend receipts, instead of by the ability of the company to pay dividends. Where an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company. It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors.

(f) In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

(g) Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation. Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

(h) Section 2031 (b) of the Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks which are actively traded by the public. In accordance with section 2031 (b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded in on the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is evidence of an active, free public market for the stock as of the valuation date. In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration, a corporation having one or more issues of preferred stock, bonds or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

SEC. 5. WEIGHT TO BE ACCORDED VARIOUS FACTORS.

The valuation of closely held corporate stock entails the consideration of all relevant factors as stated in section 4. Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business. To illustrate:

(a) Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.

(b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the 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.

SEC. 6. CAPITALIZATION RATES.

In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

SEC. 7. AVERAGE OF FACTORS.

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

SEC. 8. RESTRICTIVE AGREEMENTS.

Frequently, in the valuation of closely held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer. Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. *See* Rev. Rul. 54-76, C.B. 1954-1, 194. However, in such case the option price is not determinative of fair market value for gift tax purposes. Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bonafide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. In this connection see Rev. Rul. 157 C.B. 1953-2, 255, and Rev. Rul. 189, C.B. 1953-2, 294.

SEC. 9. EFFECT ON OTHER DOCUMENTS.

Revenue Ruling 54-77, C.B. 1954-1, 187, is hereby superseded.