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IF YOU CAN'T COME THROUGH THE FAMILY ATTRIBUTION FRONT DOOR, TRY THE BACK- THE IRS "SWING BLOCK" RULING

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Introduction. Revenue Ruling 93-12 was lauded by the estate planning community as the Service's belated, but ultimate acceptance (in at least one specific instance) of the use of minority interest discounts for transfers of interests in family owned, closely held corporations after repeatedly losing in the courts on its "family attribution" position. Previously, the Internal Revenue Service had maintained that even though family members might individually hold minority interests, the value of such shares should not be discounted for lack of control. This was based on the theory that family ownership should be viewed as one voting unit ("attributed") and assumed to act in unison. Thus no single family shareholder, even if holding a minority interest, suffered the reality of a lack of control. Therefore, the IRS had maintained that no family interests should be valued with respect to minority discounts, and instead should be valued based on their prorata share of the 100% control value of the business.



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As with the movie *Jaws*, just when practitioners thought it was safe to go back in the water, a new creature reared its ugly head- the IRS "swing block" ruling. The issuance of *Technical Advice Memorandum (TAM) 9436005* (referred to hereinafter as the "swing block" ruling) shows that the IRS is at least attempting to reduce or eliminate minority interest discounts with

the consideration of "swing vote" attributes associated with a transferred interest. In effect, if a minority interest could be disallowed, the IRS is ultimately inferring that in some cases a minority share holding might even be valued as if it were a controlling interest. This ruling could create a whole host of new potential valuation and estate planning issues and problems, albeit with no subsequent case law guidance or official IRS pronouncements.

This article begins by addressing the substance of the swing block ruling and the IRS rationale for why it believes it has a foundation for this view, followed by a brief analysis of various cases that touch on the issue. Finally, a discussion is presented of the implications of this letter ruling and how it conflicts with what is contained in Revenue Ruling 93-12.

This article raises very real and practical problems in knowing just what to do on the minority discount issue given the Service's swing block ruling. While some seem to believe there is little or no validity in the IRS ruling, this might be an incorrect and dangerous point of view. In the real world there are indeed situations where a swing block can be very valuable even though it is a minority interest.

All Minority Shares Are Not Created Equal. In Technical Advice Memorandum (TAM) 9436005, the IRS rules on a situation where a donor owns 100% of the outstanding common stock of a corporation and simultaneously transferred blocks of 30% each to his three children and 5% to his spouse. The transfers were all valued at net asset value with minority interest and lack of marketability discounts of 25% in total. The IRS

SWING BLOCK (continued)

ruled that the swing vote attributes of each block should be considered as each family owner could join with a second 30% family owner and exert control over the corporation.

Back to the Future. The additional reasoning is even more disturbing- timing of the transfers is irrelevant. The IRS asserts that even if the transfers had been completed at different times, the result would be the same, that is, the first transfer of 30% would not carry any swing vote attributes, but transfer of the second and third blocks would carry swing vote attributes. Moreover, the IRS stated that the value of the first transferred interest would increase once the second transfer occurred because the first block would then have enhanced control aspects.

Think about the practical implications of this line of thinking. On its face this logic implies that the valuation of a current gift of shares (today) might be impacted by future unknown gifts which have yet to occur. How is an attorney or business valuator realistically able to interpret some unknown future event and apply it to the current value today? If carried to its logical conclusion, it then becomes nearly impossible to estimate the value and gift and estate tax implications of any current and/or future gifts. The present value depends on the future, and the future values depend on the present. In philosophy and math class this is called “circular reasoning.”

Estate of Winkler Is The Foundation of IRS Swing Block Ruling. The IRS’s swing block rationale centers on the *Estate of Winkler (Estate of Clara S. Roeder Winkler, TC Memo. 1989-231)*, therefore, it is important to examine the facts and circumstances of this case. In *Winkler*, the decedent owned small interests in the voting and nonvoting shares in a closely held corporation. At death, the stock was to be distributed equally to three children. At the date of death, all of the voting stock was owned equally by the two families.

The estate’s business valuator valued the interests before adjustments at the same value for the voting and nonvoting shares with total adjustments for minority interest and lack of marketability of 45%. In contrast, the IRS’s expert determined that the voting stock was worth more than the nonvoting stock and the adjustments for minority interest and lack of marketability were determined to be only 25% in total. The valuator believed that the 10% voting interest had swing vote attributes. When viewed from a family attribution perspective this would result in control by one of the families.

The court ruled that a 10% voting interest did

indeed carry swing block attributes, as its holder could enjoy control aspects if combined with either family’s holdings. Discounts allowed were as follows: a 20% minority interest discount for non-voting stock, and a 25% lack of marketability discount for both classes of stock. Note, however, that this case ruling occurred in 1989, four years prior to the issuance of Revenue Ruling 93-12.

Hypothetical Willing Buyer and Seller- You Can’t Have One Without The Other. In *Bright (Estate of Bright, 658 F2d999, 5th Cir. 1981)*, the IRS raised the issue of swing vote attributes as a modification to the fair market value standard for the first time on appeal.

Fair market value is the standard of value to use in an estate or gift tax valuation, and is defined as “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.” From a valuation perspective, the parties are considered to be a hypothetical willing buyer and seller, not a specific buyer and seller. The IRS argued that the identity of other shareholders would be known by the parties and would be considered in determining the stock price. The court declined to rule on the issue, but the dissenting opinion stated that if a seller knew that the block being transferred would give control to other shareholders, it “might” affect the price of the interest. This contradicts the hypothetical willing buyer-willing seller foundation for valuation purposes.

Assessing the Family “Market” For Valuation Purposes. Even though the court declined to rule on this issue, the pivotal point in acknowledging swing vote attributes in *Bright* depended on the known *intent* of the other shareholders to acquire control, that is, a ready “market” for the interest. Therefore, theoretically, the value of the shares offered by a hypothetical seller differs depending on who seeks to purchase them and whether such intent is indicated. Taking this line of thinking further, if the value of a transferred interest can be affected by the existence of a ready market among the other shareholders, then the validity of that market should be considered.

In *Winkler* the court did not test the validity of the “market” for the shares and in fact ignored the evidence presented in the case that there was no intention to change the balance of control between the families. The court assumed that the family that owned the shares could be considered to act as a single unit to obtain control and would bid up the price for the interest. The valuator for the IRS admitted that the

SWING BLOCK (continued)

family members were considered as one individual in determining the amount of minority discount. Without the circumstances of the possible competition for the interest between the two families, the appraiser agreed that the discount would be higher, and could even be at the 45% level determined by the estate's valuator.

The family attribution was important in *Winkler* because without it, the interest lost its swing vote attributes. While some families would have no difficulty acting as one unit, many other families do not. Besides, often some interests are held in various entities, making acting as one unit impossible. Assuming family attribution in *Winkler* is inconsistent with Revenue Ruling 93-12 which was intended to give guidance over the long term to taxpayers and their advisors.

The Swing Block Ruling Versus Revenue

Ruling 93-12- A Couple with Irreconcilable

Differences. In Rev. Rul. 93-12, a donor transferred 20% interests to each of his five children. The IRS ruled that a minority interest discount would not be disallowed just because aggregation of family interests would provide control, but in its swing block ruling, the IRS rules that the *swing block characteristics of each block should be considered in the valuation of the interest*, a classic example of talking out of both sides of one's mouth. Naturally, the IRS gave no guidance on how much effect should be given to swing vote attributes on the amount of minority interest discount.

Swing Blocks Can Exist in the Real World, But IRS Logic Goes Further. Remember that in specific circumstances swing vote attributes can be of real value, but only when the buyer of the shares actually receives an interest that has elements of control. For example, state law might indicate that a simple majority vote is required to merge, sell, liquidate or undertake other key prerogatives of control. Suppose your client holds a 100% interest in a closely-held business. At the end of this year he gives 48% to his daughter, clearly a minority interest. In this instance the 48% transferred gives no control, and the father still has the voting clout needed to run the business with 52% (note, however, that if state law required a super-majority, the 48% would have blocking power, although not unilateral power to act). At the end of the second year the father gives 4% to the same daughter, raising her interest to 52%, thus lowering his to 48%, a minority interest.

Under *fair market value* in the real world, this 4% truly constitutes a swing block. However, it appears that under IRS logic, the first gift of 48% would be considered in conjunction with the future 4% transfer

that took place which conferred control over to the daughter. Thus, the IRS would argue that the 48% gift, when it was made, should not have been valued as a minority interest, but instead, based on the totality of what later results (from the 4% gift) in a transfer of control. Said another way, this suggests a sort of "step transaction" type of argument is being enunciated, i.e., that it is not just the specific gifts that occur in any given year, but, instead the totality of all past, present and future gifts as a part of a whole picture.

Fortune Tellers Needed. How then, can the business valuator correctly value the first gift under this logic? Who knows! In following its swing block viewpoint, the IRS in effect says that family attribution is a factor, and that the 4% interest carries swing block characteristics, but also indicates, in effect, that the 4% gift is only part of the total picture and intent. Valuators and estate planners will now have to become certified in fortune telling to know the future to value the present.

Control Premiums Based on What? Further, if a 4% interest is indeed a swing block, on what basis can a reduced minority discount, or alternatively, a control premium, be applied? The difficulty from a valuator's point of view is that all of the studies pertaining to control premiums paid for businesses relate to the value of 100%, unilateral control. This is hardly the same animal as a 4% interest with swing block attributes, but without such complete and total influence. While it seems reasonable to believe that there is indeed a spectrum, ranging from total lack of control (a full minority discount) to total control (a 100% control premium), how does the valuator then reasonably estimate, in actual quantifiable valuation terms, where the specific swing block interest ought to fall?

Implications. Swing vote attributes are real and should be considered in a valuation of a specific interest. However, the IRS swing block ruling introduces significant uncertainty into the estate and gift tax planning area for both attorneys and valuators as the Service attempts to use the "back door" to reintroduce family attribution in another way. The ruling is very general and does not lend itself to situation specific interpretation and ease of use by attorneys and business valuators. Additionally, it raises the "back to the future" problem, i.e., that the value of a current gift of shares might be impacted by future gifts that might yet occur, but which are not yet known. How is the attorney or business valuator realistically able to interpret the consequence of some unknown future event and apply its impact in determining a share value today? If IRS logic prevails it then becomes nearly impossible to be able to know both the current and/or future gift and

SWING BLOCK (continued)

estate tax values and implications.

Further, estate planners are now faced with the IRS rationale for its “swing block” ruling, which appears to ignore the “willing seller-willing buyer” concept so fundamental to fair market value. Instead, it might require business valuers to at least consider the possible intent of other shareholders in the family- a clearly burdensome task. “Fair market value” is stated in the IRS code as the applicable standard of value for gift and estate tax purposes, so it will be interesting to see if or when the IRS ruling is ultimately tested in court and if this different standard will be upheld.

The IRS’s swing block ruling is obviously a complex legal, tax and valuation issue, the implications of which this article has only summarily touched. An outstanding resource on the “swing block” can be found in “*Swing Vote*” *Attributes of Transferred Stock*, by Mark L. Vorsatz, J.D., CPA, and William I. Woodson, M.Acc., published in the September, 1995 issue of *The Tax Advisor*.

The Moral of the Story. Estate planners should carefully understand the implications of both current and

anticipated future potential transfers of shares and how this might impact their valuation from the IRS point of view, as well as whether swing block attributes are indeed conferred. There are real world situations where swing blocks can be quite valuable, so while the IRS position has many conceptual weaknesses, there are clearly situations where this is a legitimate and unassailable valuation issue, and thus warrants a different share valuation than for other minority share interests. ♦

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