

New Regs Defuse Gift Tax Return Valuation Time Bomb

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(IRS letter received in 2018)

Dear Sir or Madam:

You filed the estate tax return for the Estate of Mr. Smith, who died January 10, 2018. As a result of our review of prior gift tax returns filed in January 2000 by Mr. Smith, we find that the gift tax returns filed did not comply with adequate disclosure requirements at that time. Therefore, no Statute of Limitations applies and the gifts of family limited partnership interests he made have been revalued for inclusion in Mr. Smith's estate. Please remit a check, made payable to the Internal Revenue Service, in the amount of \$3,728,000 for taxes due on the understatement of gift tax paid in 2000.

Attorneys and business appraisers always want to avoid a mess like the one described in this hypothetical. The use of a sound business valuation coupled with the proper documentation can certainly help.

New Requirement by the IRS

On December 3, 1999, the Internal Revenue Service made significant changes to the adequate disclosure regulations that, if followed correctly, should provide relief for business valuation professionals and their clients. The new requirements are largely items that should already be contained in a high-quality business valuation. This article briefly discusses the new regulations and highlights their implications to the business valuator. However, the regulations are quite detailed so business valuers are encouraged to access and review the full text.

Historical Perspective

Under the old gift and estate tax rules, the IRS generally could not challenge the valuation of gifts and the taxes paid on those gifts after a three-year statutory period had expired. This three-year statutory period began upon the filing of the gift tax return and the paying of the gift tax. This worked fine while the donor was alive; however, when the donor ultimately died, the IRS was free to examine the valuation of *all* prior gifts made during the donor's life in determining the donor's ultimate estate tax liability. In effect, this gave the IRS free rein to go back as many years as it liked and

challenge the valuation of various gifts made to determine the unified (gift and estate) tax liability of the donor. The taxpayer's estate was subject to potential taxes and penalties, and the business valuation professional was subject to defending old reports with valuation techniques that might have become outdated or obsolete.

Current Law

Following the Taxpayer Relief Act of 1997 and the IRS Restructuring and Reform Act of 1998, the IRS adjusted its policies concerning the examination of prior gifts. Under the new law, the three-year statute of limitations on gifts applies in both the gift tax as well as the estate tax context. Upon the death of a donor, the IRS can go back only three years in examining prior gifts.

The one catch in the new law is that the gifts made must be *adequately disclosed* (as defined by the IRS). Any gift made that is not adequately disclosed is subject to examination and challenge by the IRS at any time, including and especially at the death of the donor. If the gift tax valuation reports are adequately disclosed, the business valuation professional creates a safe harbor for those gifts made more than three years ago.

Under the new regulations, the IRS defines "adequate disclosure" in Reg. §301.6501(c)-1(f)(2), which states:

[a] transfer will be adequately disclosed on the return only if it is reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported. Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed ... if the return (or a statement attached to the return) provides the following information—

- (i) A description of the transferred property and any consideration received by the transferor;
- (ii) The identity of, and relationship between, the transferor and each transferee;
- (iii) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;

- (iv) ...[a] detailed description of the method used to determine the fair market value of the property transferred, including any financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property ... ; and
- (v) A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer ...

According to Reg. §301.6501(c)-1(f)(3), in lieu of providing the valuation detail required under (iv), the donor can submit an appraisal of the transferred property if such an appraisal satisfies the following requirements:

- The appraisal is performed by an appraiser who performs appraisals on a regular basis or holds himself or herself out to the public as an appraiser.
- The appraiser must be qualified to make appraisals of the type of property being valued and the appraisal must detail such qualifications in the appraisal.
- The appraiser is not, and does not work for, the donor or donee or a family member of either.

The regulations go on to state that the appraisal report must contain the following:

- (A) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.
- (B) A description of the property.
- (C) A description of the appraisal process employed.
- (D) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.
- (E) The information considered in determining the appraised value, including in the case of an ownership interest in a 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.
- (F) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.
- (G) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.
- (H) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

Good Appraisal Practice

Interestingly, many of the adequate disclosure requirements as well as the appraisal requirements for substitution of (iv)

above are already required aspects of any good business valuation report. Many of the above requirements are required by the Uniform Standards of Professional Appraisal Practice (USPAP). Various aspects of some of the IRS requirements are discussed below.

Property Transferred in Trust. The proposed regulations required that for property transferred in trust, the taxpayer must provide a “brief description of the terms of the trust.” The final regulations (see (iii) above) allow the taxpayer to submit a complete copy of the trust document instead of the “brief description.”

100% Control Value Not Required in Many Cases.

The proposed regulations originally required that each appraisal report of a minority interest (i.e., less than 100% interest) contain a value of both the minority interest as well as the 100% controlling value of such interest. Many objected to this proposed requirement, noting that it would require additional effort on behalf of the appraiser and cost to the taxpayer to determine the 100% control value when it might not be relevant to the minority interest being valued. This requirement also raised fears that the IRS would focus on the 100% control value as the proper value without consideration of applicable discounts for minority and marketability issues, non-voting stock, fractional interest discounts, etc. In its final regulations, the IRS has required that the 100% control value be calculated and shown in the report only if the value of the minority interest is based on a pro-rata portion of the net asset value of the entire entity.

An example of where the 100% value disclosure may be required is in the context of a family limited partnership (FLP) owning real estate. In such an appraisal, the value of limited partnership interests in the FLP (before applying discounts for minority interest and lack of marketability) is usually based on a pro-rata portion of the 100% net asset value of the underlying assets held in the partnership. An example of where the 100% value disclosure may not be required is in the context of the valuation of an operating company by using price/earnings or other ratios of publicly traded companies. Under the new regulations, the taxpayer bears the burden of proving that the minority value is based on something other than the pro-rata of the fair market value of 100% of the entity.

Statement of Contrary Positions Taken. As seen in (v) under the adequate disclosure provisions, the new regulations require the taxpayer to disclose any contrary position taken from any regulations or revenue rulings existing at the time of the transfer. This can have an impact in the valuation context on such issues as built-in capital gains. Although there is an increasing number of tax court cases that allow the consideration of some partial impact on value for built-in gains (valuators should be cautious because these cases were highly fact specific and often did not allow a direct deduction of the full impact of the

tax), the official position of the IRS still remains that such gains cannot be considered in the valuation of an entity. If the business appraiser believes the recent line of cases gives him or her enough precedent to incorporate a discount for such a gain, the appraiser needs to note in the report that this discount is contrary to the current IRS position. In effect, this is the equivalent of stamping “Audit Me” on the valuation report.

Appraiser Requirements. As seen in the appraisal requirements section above, it is important that the appraiser have the qualifications, background, experience, education, and membership in professional appraisal associations to be experienced to perform the type of appraisal required.

Appraisal Requirements. There are numerous requirements of the business appraisal itself, all of which constitute sound appraisal practice. The requirements should be a part of any business appraisal and not just those utilized for gift and estate tax purposes. An appraiser who shortcuts the process is doing his or her client a greater disservice by subjecting the report to possible attack by the IRS.

Conclusion

Good and thorough work reduces the chances of problems down the road. The IRS has given business appraisers some specific rules and the burden is now on each business appraiser to follow those rules carefully and save their clients needless expenditures of time and money. ♦