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Recent Developments in Estate Planning: Selected 2019 Gift and Estate Tax Cases

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<u>Jones Estate v. Commissioner, T.C. Memo. 2019-101</u>
(August 19, 2019)

The taxpayer was the founder and majority owner of two closely held family businesses, Seneca Sawmill Co. ("SSC"), a lumber manufacturer taxed as an S corporation, and Seneca Jones Timber Co. ("SJTC"), a limited partnership that owned timberland and supplied timber to SSC. SSC was the sole general partner of SJTC.

As part of the taxpayer's succession planning for the businesses, in May 2009, the taxpayer made gifts of non-controlling interests in SSC to certain trusts for the benefit of his daughters and their families and gifts of limited partnership units in SJTC to his daughters.

The taxpayer reported these gifts on a timely filed Form 709 based on valuations of the gifted interests. The IRS subsequently issued a notice of deficiency based on higher determinations of the values of the gifted SSC and SJTC interests.

On petition before the Tax Court, the sole issue was the valuation of the gifted SSC and SJTC interests. The taxpayer submitted an expert report that valued the SSC and SJTC interests based on a combination of an income-based approach and a market approach. The IRS submitted an expert report valuing the SJTC interests based on a combination of an asset-based approach and a market approach, but did not submit a report as to the valuation of the SSC interests, relying instead on an expert to rebut the taxpayer's expert report as to SSC.

The Tax Court adopted the values from the taxpayer's expert report in their entirety, and in so holding addressed several issues disputed between the parties:

- The Court held that in valuing SJTC, the taxpayer's income-based approach, which valued the business based on the projected income from its sale of timber, better reflected the business' value than the IRS' asset-based approach, which assigned a higher value to SJTC based on the value of its timberland holdings. The Court reached this conclusion primarily because the circumstances of SSC and SJTC, specifically SSC's control of SJTC as its general partner, rendered it unlikely SJTC would ever sell its timberland, thus making an asset-based approach to valuing SJTC less appropriate.

- The Court held that it was appropriate for the taxpayer's expert to have relied in his report on a revised cash flow projection prepared for SJTC in April 2009, two months after SJTC's annual report, concluding that the April 2009 report better reflected the broader economic conditions closer to the date of the gifts in May 2009. Incidentally, the IRS' expert had also relied on the April 2009 report in preparing his report.

- The Court upheld the appropriateness of the taxpayer's expert "tax affecting" the earnings of SJTC and SSC in valuing the entities, a process whereby the expert applied a proxy tax rate to approximate the taxation of the entities as if they were C corporations in order to account for the benefits and drawbacks of their taxation as pass-through entities. In reaching this holding, the Court distinguished several prior cases that had disallowed use of a "tax affecting" approach on the basis that the facts in those cases – rather than a flaw in the approach per se – had made application of the approach inappropriate in those cases.

  An application of the "tax-affecting" methodology was also accepted by the U.S. District Court for the Eastern District of Wisconsin in its decision in *Kress v. United States*, 372 F. Supp. 3d 731 (E.D. Wis. 2019) filed on March 26, 2019. In *Kress*, the Court accepted the use by both the taxpayer's and the IRS' expert of a "tax-affecting" approach in order to value a family-owned S corporation based the values of comparable C corporations.

- The court upheld the taxpayer's expert's approach in his report in treating an intercompany receivable from SJTC held by SSC as an operating asset, reasoning that this approach best reflected the relationship of SSC and SJTC as interdependent parts of a single business enterprise.

- The Court rejected the IRS's argument that the general partner interest in SJTC owned by SSC should be valued as a 10% interest in SJTC itself rather than based on the expected distributions from SJTC to SSC that the general partner interest represented. Again, the Court reached this decision on the basis that the taxpayer's expert's approach better represented the reality that the two entities were interdependent parts of a single business enterprise.

- The Court adopted the taxpayer's expert's 35% lack of marketability discount applied to the valuation of SJTC over the IRS' expert's 30% discount on the basis that the IRS' expert's figure did not take into account restrictions on transferability in certain buy-sell agreement governing SJTC units.

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Estate of Dieringer v. Commissioner, 917 F.3d 1135 (9th Cir. 2019)
(March 12, 2019)

The decedent died in April 2009 owning a majority interest in a closely held family business called Dieringer Properties Inc. ("DPI"). The decedent's estate plan provided that the residue of her estate would pass to a private foundation (the "Foundation") established by the decedent during her lifetime. The decedent's will appointed her son as the executor of her estate, the same son also being the president and a shareholder of DPI as well as the sole trustee of the Foundation.

After the decedent's death, the executor obtained an appraisal of the decedent's interests in DPI, which included both voting and nonvoting shares of the company, determining the date-of-death value of the interests to be approximately $14.2 million. The valuation reflected a 5% per-share discount for the decedent's non-voting shares, but did not otherwise reflect any discount for lack of control or lack of marketability.

Soon thereafter, before the residue of the estate had been distributed, DPI entered into an agreement with the decedent's estate to redeem a portion of her interest in DPI, being all of her voting shares as well as approximately 72% of her nonvoting shares. In connection with the redemption, the executor arranged for an updated appraisal of the shares subject to the redemption as of the date of the agreement in November 2009, instructing the appraiser to value the DPI shares as if they were a minority interest (notwithstanding that the interests to be redeemed represented a controlling interest). The November 2009 appraisal, which valued the decedent's DPI shares subject to the redemption at approximately $5.2 million, reflecting a 15% lack of control discount and a 35% lack of marketability discount, in addition to reflecting a different underlying value for DPI due to declines in the market since date of death.

Following the redemption of a portion of the decedent's DPI shares at a total price of approximately $5.2 million based on the November 2009 appraisal, the residue of the estate was distributed to the Foundation.

On the estate's Form 706, the executor claimed a charitable contribution deduction which included the approximately $14.2 million date-of-death appraised value of the DPI interests that would, in theory, pass to the Foundation. Meanwhile, the Foundation reported a receipt of assets from the estate worth approximately $7 million on its 990-PF, and the estate reported capital losses resulting from the redemption transaction on its Form 1041 totaling approximately $5.2 million.

The IRS issued a deficiency notice in connection with the Form 706, reflecting an estate tax deficiency and a substantial accuracy-related penalty on the basis that the estate had used the date-of-death appraised value of the DPI interests in calculating its estate tax charitable deduction, and instead should have based the deduction on the value of the assets actually received by the Foundation as affected by post-death events.

The Tax Court upheld the IRS' imposition of the deficiency and penalty based on a reduction of the estate's estate tax charitable deduction, and the Ninth Circuit affirmed on appeal. In so holding, the Ninth Circuit affirmed the general legal principle that an estate tax charitable deduction is valued separately from the valuation of the gross estate and "is subject to the principle that the testator may only be allowed a deduction for estate tax purposes for what is actually received by the charity." The Ninth Circuit affirmed that the reduction in the value of the property passing to the Foundation was primarily due to what it characterized as abusive manipulations of the executor, rather than due to a decline in the market between date-of-death and the DPI redemption agreement, and accordingly sided with the IRS' calculation of the charitable deduction based on the value of the property actually received by the Foundation.

Cavallaro v. Commissioner, TC Memo 2019-144
(October 24, 2019)

The taxpayers, a married couple, were the owners of Knight Tool Co., Inc. ("KTC"), and their three sons were the owners of Camelot Systems, Inc. ("CS"). The taxpayers and their sons merged the two companies in 1995, with CS being the surviving entity.

In the course of an examination of the taxpayers' 1995 income and gift tax returns, the IRS determined that the taxpayers, in valuing the two companies for purposes of the merger, had incorrectly assumed that CS owned certain valuable intellectual property that was instead actually owned by KTC. The IRS concluded that the taxpayers had therefore accepted a disproportionately low number of shares in the new company resulting from the merger, and their sons received a disproportionately high number of shares.

Accordingly, the IRS determined that the taxpayers had made disguised gifts to their sons and in 2010 issued a notice of deficiency to the taxpayers for underpayment of gift tax.

On petition before the Tax Court in *Cavallaro v. Commissioner*, T.C. Memo. 2014-189, the Court held that the taxpayers had failed to meet their burden to prove the respective values of KTC and CS in defending their allocation of shares of the new company in connection with the 1995 merger. On the basis of that failure, and in consideration of the valuations of the companies put forward by the IRS via its expert, the Court held that the taxpayers had made gifts to their sons in 1995 totaling $29.7 million.

On appeal, the First Circuit affirmed the Tax Court's factual findings and its holding that the taxpayers bore the burden to prove the values of the two companies at the time of the merger. However, the First Circuit also held that the Tax Court had erred in its statement of the content of the taxpayers' burden of proof and concluded that the Tax Court should have considered the taxpayers' arguments rebutting the IRS' expert's testimony and report on the valuation of the companies, in order to determine whether the resulting valuation determination was correct.

On remand, the Tax Court considered the taxpayers' arguments concerning the IRS' expert's testimony and report, and ultimately held that the report contained an error necessitating a reduction of the Court's determination of the taxpayer's 1995 gifts to their sons to a total of $22.8 million.

The taxpayers' arguments on remand regarding the IRS' expert's valuation report included the following:

- That the report didn't reflect a "cloud on the title" resulting from purported ambiguity as to whether KTC or CS owned certain valuable intellectual property at the time of the merger. The Court rejected this argument out of hand as it contradicted the Court's earlier determination, affirmed on appeal, that KTC was the owner of the intellectual property in question at the time of the merger.

- That the IRS' expert was biased in favor of the IRS and effectively served as a member of its trial team. The Court rejected this argument, stating that it found the IRS' expert generally credible in his report and testimony and pointing out that the expert's valuation had actually resulted in the IRS making substantial concessions on the valuation of the companies before trial.

- That the IRS's expert should not have performed a profit reallocation calculation between the two companies as part of his valuation methodology. The Court found that such reallocation was necessary to correct for certain distortions in the profit allocations between the two companies, which the Court found were not dealing with each other at arm's length prior to the merger.

- That the IRS' expert erred in his calculation of the profit reallocation, specifically with regard to how the expert calculated the hypothetical profitability of each of the two companies based on industry benchmarks. The Court agreed with the taxpayers, finding that the IRS' expert had erred in his projection of the profitability of KTC, which had resulted in a lower valuation of KTC and therefore a higher total computation of the taxpayers' 1995 gifts. This was the sole factor influencing the Court's conclusion that the total value of the taxpayer's gifts should be reduced to $22.8 million.