ESTATE PLANS IN CHAINS – THE UNFORTUNATE TREND TOWARD UNNECESSARY DISCOUNT CAPS

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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1802
Date: 21-Apr-11
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Dennis Webb: Estate Plans in Chains the Unfortunate Trend Toward Unnecessary Discount Caps**

Discounts for fractional interests in real estate, including partnerships, LLCs and all manner of holding such assets, have been an ongoing issue for estate practitioners. **LISI** has been reporting many views of court cases, legislation, conferences and other commentary involving discounts; in all, 850 newsletters since 1998 mention discounts.

One would think that the subject would have become less contentious over time, as the players (appraisers, IRS, Court and attorneys) air their views, but if anything, the opposite is occurring. Audits still proliferate, Judges still voice frustrations, IRS is ramping up enforcement, and attorneys find themselves trying to figure out how to successfully incorporate discounts in taxpayers' estate plans. It's clearly not working.

Now **Dennis Webb** adds his thoughts to the dialogue, with a provocative point of view. He observes that some lawyers are instructing appraisers to artificially cap discounts at specific percentages in order to fly under IRS radar, even when the correct and supportable discount would be much greater. Thus, a simple desire to protect clients, lawyers and appraisers from IRS audits may now be causing rampant overstatement of tax liability. He contends that capping discounts and overstating value should be an unnecessary tactic, and advocates for the "right" discount; showing how attorneys can engage appraisers to obtain a full measure of tax benefits for their clients while also providing what the Courts and IRS see as the most helpful evidence for value.

Dennis's commentary is connected with an upcoming conference that will be held in Los Angeles on May 18th: the Third Annual IRS Valuation Symposium. The Symposium has an unusual appeal because it takes a very different tack than most valuation conferences. This meeting features IRS presenters almost exclusively,

plus Judge Halpern. The idea is to get their views fully presented, with valuation panelists available to clarify controversial positions and identify real solutions. As Dennis co-chairs the conference and will be moderating the questions, he asks **LISI** members to submit questions for Judge Halpern and the IRS presenters to him directly at his email address provided below. Dennis will be authoring a newsletter for **LISI** that summarizes the proceedings.

Dennis A. Webb, ASA, MAI, FRICS is designated in both real estate appraisal and business valuation, and has specialized in fractional interest valuation for more than 15 years. He is a frequent speaker, and his articles have appeared in Valuation Strategies, Estate Planning, The Appraisal Journal, the Journal of Business Valuation and Economic Loss Analysis, and others. He wrote the case study textbook "Valuing Undivided Interests in Real Property: Partnerships and Cotenancies" published by the Appraisal Institute. Most of his publications and papers are available at: www.primusval.com. Dennis is also co-chair of the upcoming Third Annual IRS Valuation Symposium to be held on May 18 in Los Angeles, where the sorts of issues presented here will be discussed in detail. In the past, Dennis has provided **LISI** members with his views on case of Ludwick v. Commissioner in Estate Planning Newsletter #1687, and can be contacted at: dwebb@primusval.com (949) 443-0800

Now, here is Dennis's commentary:

EXECUTIVE SUMMARY:

"Hello? Mr. Webb? This is Lawyer Larry calling. I need a valuation of three family limited partnership interests for gifting purposes…I understand that discounts under 35% are acceptable to the IRS, and so we would like your valuation to conclude discounts no greater than 35%…"

This is an increasingly common phone conversation, and the issue that the caller has raised is a complex one. It is the unfortunate product of beliefs about valuations and audits that have developed over the past few years, as a result of stepped-up enforcement with value misstatement penalties, tax court cases that demonstrate a lack of confidence in valuations, and chiefly, a desire to avoid audit. It is part of a long-running battle over discounts that show no signs of letting up.

The idea of forcing the appraiser to conclude a "conservative" value, amounts to having the client overpay the government in the belief that it will provide audit protection. The logic seems reasonable, but is heavily flawed. From the valuation

side, it pushes the appraiser in the direction of violating his practice standards and ethics, because it asks him or her to bias the conclusion in the IRS' favor.[I]

The appraiser's target is the "right" value, supported by market evidence and the facts and circumstances of the case. If it is then expressed in a report that is persuasive and easily understood, it will provide satisfactory evidence for both IRS and the Court. It is the author's experience, with 15+ years of providing fractional interest valuations, that a valuation that targets the "right" value in this way is, in fact, acceptable, a notion confirmed by results.[II] The "right" discount can vary greatly, of course, since fractional interest positions can be highly attractive or frighteningly risky and onerous.

Capping the discount in hopes that audits will be avoided is expensive and unnecessary. A supportable opinion of value will be successful, because it answers the stated needs of the opinion's audience: The IRS and the Court. It simplifies life for Government reviewers, and supports a win for the attorney and his or her client. What's not to like?

COMMENT:

The idea that the IRS will give a pass to, say, a 35% FLP interest discount, is becoming a sort of urban legend. Lawyers are more and more frequently asking that appraisers keep those valuation discounts down to provide some audit insurance. Maybe the estate has skeletons in its closets, and playing it cool is an important tactic. Maybe the attorney has read **Judge Halpern's** opinion in Ludwick,[III] noticing that the Judge disregarded all the appraisers' analysis and conclusions (he resorted to preparing his own), cementing his own view that valuation reports are confusing and unpersuasive by their nature, and relying on them can be dangerous. Maybe the attorney is indeed conservative with his advice, and the client is correspondingly risk-adverse and doesn't mind paying more tax if it will buy peace of mind.

Stepped-up Enforcement

This assortment of fears is in part well-founded. IRS has indeed stepped up enforcement activities, focusing on what the Service considers abusive practices. It has obtained enabling legislation from Congress and set up quite onerous penalties for appraisers whose concluded values are at substantial variance from IRS' values, under §6695A.[IV] Issues with discounts still amount to the lion's

share of IRS valuation work, and those little checkboxes on Forms 706 and 709 allow the Service to screen pretty effectively.

This all begs the issue of whether there is a formal or informal "safe harbor" for discounts. The Service has publicly stated that there is none, and as a practical matter, it's the potential for collection that drives audits. A very large estate or gift may be complex to audit, but even a few points on the discount might yield a good return on the effort. Hours spent on valuation audits show a very substantial return. When there is a large dollar amount on the line, only a very small discount would be necessarily "safe." It's not the percentage, it's the $$, and providing evidence for value is the taxpayer's responsibility.

It's the Appraiser's Role

An appraiser is hired by the taxpayer, but the user of his or her report is also the IRS and perhaps the Court. The ethical and professional obligation not the same as the attorney's – it is to be an unbiased arbiter of value. Bias is unethical. There is nothing wrong with the attorney stating a desire to limit the discount, but there is a lot wrong with the appraiser accepting the assignment on that basis. It also turns out to be quite unnecessary. The discounts we are concerned with are fairly high in most instances, and as long as the process is followed carefully and completely, all concerned should be satisfied with the result.

The essential elements are quite straightforward: Market evidence for value, and the facts and circumstances of the case; specifically, what exactly does the discount have to do with the facts? One would think this would be commonly demonstrated, but it is not. Attorney **Chuck Morris**, a former IRS Gift & Estate Territory Manager, has publicly pleaded with appraisers on several occasions, asking "please… tell me what your analysis has to do with the facts!"[V]

The valuation process is the science and sometimes art of connecting specific facts with available market data concerning control and marketability impairments and performance forecasts. The best guide to finding relevant facts would be the considerations that a buyer of the interest would have; and that would be revealed in its due diligence.

If I were considering buying a 10% member interest in an LLC, I would want to know at least how much cash flow I would receive, plus its risk and duration. A 12% annual cash flow from long-term triple-net leases with credit tenants and a liquidity event in 10 years or less (where I would get my 10% of net asset value), plus very competent managers with a solid history, might encourage me to offer

that 35% discount from net asset value. But if the LLC holds grazing land that might find a higher use two generations from now, returns only 2% when beef prices are high, has a history of capital calls when cash runs short, and has ornery managers are fairly young, like running cattle and have iron control over the entity, I might not be interested at even a 60% to 70% discount. The seller might even want out at that discount. Reality suggests that facts drive the analysis.[VI]

It is no secret that appraisers are not universally qualified, and appraisals not universally persuasive. Why should valuation be different from any other profession in this respect? Professional qualification is a huge issue, particularly when the work product – the appraisal report – is often an indecipherable document. This should not be the case; a good report's presentation of the case facts and arguments for value is clear, persuasive and easy to understand. It makes sense.

The Attorney Steps In

The question is: How can the attorney tell whether the value opinion is reliable and persuasive? For starters, the report should not rely on obtuse logic and blind assertions. The connections between the case facts and the discount analysis should be clear and convincing.

Attorneys are practiced at making and reviewing persuasive arguments, and can apply those skills in reviewing the appraisal and offering comments to the appraiser. The specific steps that can be taken are described in a recent article, co-authored with attorney **Susan Beveridge**, that appeared in Estate Planning.[VII]

Additionally, the attorney might want to look over some of the appraiser's previous work, assuming it is unfamiliar. Can it be easily understood? Does its reasoning make sense? What is the appraiser's record with IRS audits? Why do some appraisers have no audits, and others generate lots of them? Audits can have many triggers, but still, discounts should not be a chief or frequent target. Your appraiser probably shouldn't be on a first name basis with the local revenue agents. Review their qualifications, but beyond qualification, do they have a willingness to do what it takes to dig out the facts, and then connect the facts with the analysis. This is what really distinguishes the successful appraisers and their persuasive reports.

Working toward a Solution

Professional qualification and the Service's expectations are a big deal. The American Society of Appraisers (ASA) and others have been working directly with

IRS to address a list of concerns, and lobbying to convince Congress that appraisers with meaningful credentials do have the skills and independence needed to perform fair and reliable tax-related appraisals. Further, IRS has been offering their views on what they need to see in order to give appraisal work a pass. ASA began presenting conferences in Los Angeles in 2006, as the new enforcement efforts got underway. Another such conference (the Third Annual IRS Valuation Symposium) is being offered in May 2010. It is an opportunity for tax practitioners and appraiser both to hear these issues addressed in a direct and candid forum; a summary of the proceedings will be reported in **LISI**.

Conclusions

That phone call from Lawyer Larry asking for a capped discount is a symptom of a last-ditch effort to save estate plan benefits and keep clients away from audit. But the suggested discount cap is not a solution. You won't need it if your plan generates supportive facts and you file a good appraisal report. The lawyer has control over both – more control, in the case of the appraisal, than most attorneys are willing to admit.

Success involves a much more serious engagement between attorney and appraiser, and presentation of clear, convincing evidence for the "right" discount that will be well-received by IRS and benefit the taxpayer. If it comes to it, such evidence will make the Court happy, too. There is often a lot at stake; the attorney can get a much better result for his client by putting in some effort to obtain a good appraisal that strongly supports the proper discount, than by artificially capping the discount and hoping to fly under the radar.

I empathize with attorneys because they did not create the problem, but now that the issue is on the table, they need to be attentive to the solution. Not to create another urban legend, but to make a big difference with taxpayers and the government – they are a key part of the solution. Tax-writing committees in Congress, observing these sorts of conflicts, may continue to impose draconian "solutions" of their own. Taxpayers, attorneys and all of us deserve better.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Dennis Webb

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CITATIONS:

[I] For establishing basis, and for charitable contributions, "conservative" takes on the opposite meaning. The only way out is to report the "right" value.

[II] The result has been that the author's discount opinions have never been challenged. Of course, not everything is scrutinized for various reasons, and no one can ever guarantee audit-proof work. It also doesn't necessarily mean there weren't any, it's just that we don't know about them. (There have been a few audits over the period, but for other reasons: real estate valuations a couple of times, and one blockage discount involving a large holding of public stock.) One clearly accepted-as-filed valuation had concluded an 85% discount because it was supported by the facts. In this writer's view, being "conservative" looks like staying out of audit. Conversations with IRS examiners typically occur when we are retained to defend others' work, or consult with counsel; for example, see Tax Court Tool Blunts IRS Challenge. My conclusions are based on direct public statements by IRS valuers and managers, gathered from presentations I have made to this group, and my experience that submitting evidence for the "right" discount indeed works.

[III] Andrew K. Ludwick, et al v. Commissioner, TC Memo 2010-104. See also "Ludwick: A Wake up Call for Lawyers" LISI #1687.

[IV] Revisions to Circular 230 in 2004 empowered the government to censure CPAs, attorneys and others, and to impose monetary penalties. A new civil penalty for appraisers, §6695A, was added in 2006. In LISI #1031, Zeydel, Gans and Blattmachr shared their views on the §6695A penalty "…which they point out is a problem for all of us, not just for appraisers." §6695A and gross value

misstatements is discussed more recently in LISI #1580, along with §6701, which provides a penalty for aiding and abetting understatements.

[V] Chuck Morris, JD, is now an attorney in private practice with Albrecht & Barney in Irvine, California. He had been the Western States Territory Manager for the IRS Estate & Gift Tax Compliance until 2008. Chuck will be addressing current E&G issues at the May 18 Symposium.

[VI] See "Asset Fractions: Integrating Real Property and Business Valuations (Getting a Handle on the Facts)," a paper presented at the ASA International Conference, July 15-18, 2007, Los Angeles, CA. This paper details most facts that are encountered with holding companies, and how they can be connected with the market data and valuation process.

[VII] Susan A. Beveridge, Attorney and Dennis A. Webb, ASA, MAI, FRICS "Reappraising the Appraisal Process: A Guide to Successful Results," Estate Planning, (September 2010): 11-18. This article details the active role estate practitioners can take to manage the roles of appraisers in a way that supports persuasive and convincing evidence for value, without having to become experts themselves.

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