

# Estate & Gift

Valuation Issues and Procedures

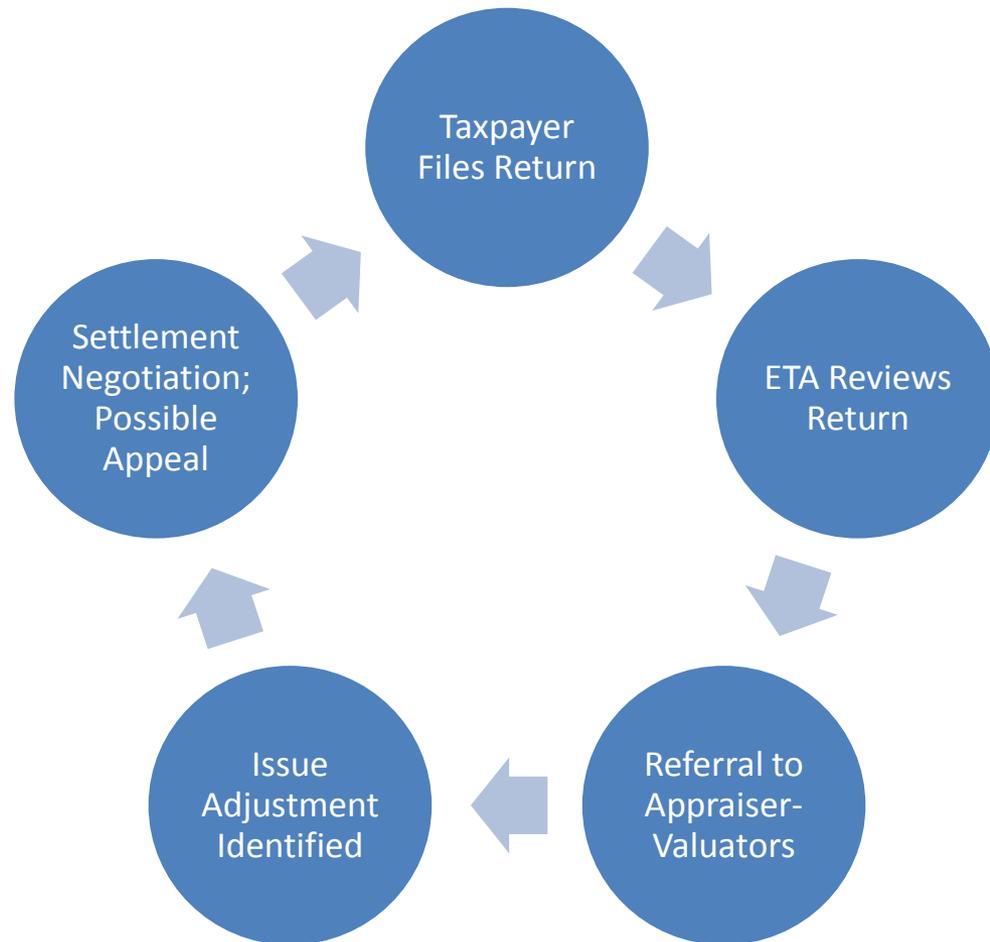
# Estate & Gift Program

Estate, Gift and Generation-Skipping taxes comprise the three forms of 'wealth taxation' that the federal government taxes. This is an excise tax, meaning it is not imposed on the transferred property itself, but on the privilege of making the transfer.

# IRS Estate Tax Attorneys

- Conduct field examinations to determine liability for Federal estate and gift taxes. The position requires professional legal knowledge of Federal, State and local laws and all ETAs are required to be admitted to a state bar.

# The Estate & Gift Tax Environment



# Unique Methodologies, Theories and Concepts

- Since the transfers are gratuitous (no arms length sale) there often is no actual proof of the fair market value of the property. If the transferred property is fungible and freely traded, like stocks, bonds or single family residences, a market price can usually be derived.

# Unique Methodologies, Theories and Concepts

- However, for unique items, such as a closely held business entity that holds real estate and publicly traded equities, the transfer tax system, the court and appraisers have developed very elaborate appraisal methodologies with several discounts presumed.

# Date of Valuation

- Gift Tax – the date ownership transferred is the effective date of value.
- Estate Tax – Date of death or taxpayer (estate) can elect Alternate Valuation Date.

# Highest & Best Use

- Normally real property is valued at its highest and best use.
- Special Use Valuation – Section 2032A allows estates to elect to value farms and closely held businesses on the basis of its “current” use rather than the highest and best use.

# Section 2032A Valuation Methods

- Two valuation methods are used for farms and closely held businesses that qualify for special use valuation:
- Farm Method
- Multiple Factor Method for Closely Held Businesses.

# Valuation of Business Entities

- GS-13 Appraisers are programmed to be trained to perform valuations of business entities as well as real estate.
- For many, the course from which this presentation is derived is their first introduction to business valuation.
- (*The taxpayers estate should direct appropriate focus on this aspect, as well as the substantive BV issues*)

# IRS E&G / Appraiser Procedures

- The initial discussions between ETAs and Appraisers should represent:
  - a team product
  - timely and open communication
  - discuss all issues related to planning\*
  - include potential tax effect of proposed changes
  - time & information will vary (continued)

# IRS E&G / Appraiser Procedures

- The results of the previous steps are incorporated into a written agreement between ETAs and Appraisers (Large Business & International Division Engineering & Valuation, Field Specialist Team Members).
- This written agreement (letter of engagement) is a signed agreement that defines the scope of work and working relationship between attorney and valuator and should be brief – not to exceed two pages.
- **It is a discoverable document.**

# Engagement Letter Format

- No Template (**untrue**)
- Determined by E&G / Engineering teams (**inserting non standardization into a process intended to be standardized and uniformly applied**)
- Reviewed by Team Managers (**subjecting appraisers to potential result- influence abuse**)
- Consistent use

# Contents

The agreement must contain and address seven key factors as follows:

1. Purpose of the engagement
2. Identification of the subject property
3. Scope of work to be performed
4. Date of valuation
5. Estimated date of assignment completion
6. Estimated hours required for completion
7. Agreed limiting conditions

# Continued

The appraiser – Valuator and attorney all document the “engagement letter activities” on IRS form 9984 (Record of Revenue Agent Activity). This is both a filed hard copy form and an electronic record tied into the IRS information Management System (IMS)

- It would be prudent for a taxpayer’s estate in any appeal or pending tax court hearing to insist upon copies of this document. (FOIA)

# Development

The engagement letter should outline:

The work product defined by the Valuator

The activities to be performed as determined by the Attorney

- Description of assignment
- Taxpayer information

# Options

The agreement may provide various work products:

- Review or critique
- Range of values
- Reasonable discounts or values;
- Complete or limited appraisal;
- COTR Services – Outside expert report
- ***May involve manager resolution***

# Contract

- The agreement is a service contract between the IRS E&G Attorney and the IRS Appraiser-Valuator.
- The agreement may require alteration due to changes in:
  1. scope of work
  2. work product
  3. Completion date(s)

# Continued

4. Total hours, etc.

*All significant changes ;*

1. Must be agreed to
2. Should be noted in the original agreement
3. May require an amended agreement (if extensive)

# The Valuation *Team*

The E&G referral may require more than one valuator:

- A real estate appraiser
- An engineer
- Valuation specialist
- The work specific to each is described in one engagement letter.

# Process

- Attorney / Valuator discuss letter.
- Valuator prepares letter.
- Attorney concurs and signs letter.
- Manager receives a copy (E&G Team Manager and Valuator Team Manager)
- *There are numerous “sample” letters. Non template comments to the contrary, that is exactly how the samples are used.*

# Case Status Procedures

- The original case status report is (supposed) to be ETA prepared, and sent to the valuator.
- The ETA is responsible for accuracy of sections identifying the Valuator, requester, taxpayer and case
- Valuator is responsible for monthly update portions of report.
- *NOTE: ETA entry of case data into IMS is a new procedure; prone to numerous errors.*

# Original Status Report

The original status report is;

- sent to the valuator
- Copied to E&G/Engineering managers
- E-mail subject line always “Case Status Report”
- E-mail subject line – sanitize taxpayer’s name
- Send as an attachment
- Secure E-Mail
- Alternative secure method if email unavailable.

# Supplemental Report(s)

The supplemental case status reports are:

- Prepared by the valuator
- Sent to ETA monthly
- Copied to E&G/Engineering managers
- Include “case status report” in subject line
- Sanitize taxpayer’s name
- (remainder same as forgoing)

# Protocols

- All date changes communicated promptly to the ETA
- ETA & Valuator document on form 9984 activity record
- All issues worked out between the ETA and Valuator.
- Manager resolution if necessary
- Supplemental pages attached as necessary

# Proceduaraal Flaws

- The system itself assures that less than impartial treatment results once a 'direction' of audit adjustment, or probability of a possible adjustment is discussed between valuator and ETA.
- ETAs tend to require verbal information from disciplines trained not to disclose such information until a formal report is completed.

# In Real World Practice

- The ETA proposes an adjustment to the taxpayers estate before a written report is ever issued by valuers, based on verbal communications.
- The fact of, and amount of any proposed adjustment cannot possibly be known with any degree of reliability until the valuator has prepared an in depth analysis that would form the basis of any report.

# “Negotiated Values”

- Real estate Appraisal has no provision for a negotiated ‘fair market value’. While a comparatively narrow range of value may exist for any one property, that range should not be subject to negotiation if the appraisals have been properly performed.
- NEVER assume that the IRS appraisal is correct, or ‘more correct’.
- It may not even have been prepared by an appraiser!

# Negotiated - Continued

- Business or Entity Level FMV's may well be more suited to negotiation due to greater numbers of variables, and absence of truly relevant, recent 'market data.
- IRS would prefer to 'disprove' a taxpayer position, than to generate completely new, independent data. It's easier and faster to use the taxpayers information against them.

# No Safe Haven Discount

- Taxpayer representatives have sought a defined safe haven amount from IRS for many years.
- IRS official position is that no safe amount exists. Each case is based on its own merits.
- As a practical matter, LB&I would not normally recommend pursuit of adjustments less than 10% of gross estate value; or

# Haven - Continued

- Amounts that are less than the cost in time and resources to recover, unless tax abuse is suspected
- Typically, a fractional interest discount of 15% or less for an undivided tenant in common interest is not likely to result in an audit adjustment.
- IRS will use several methods to document discount rates, but ultimately for the above TIC interest, ONLY the cost to partition approach is going to be given any credence in California.

# Partition

- IRS will take a six month uncontested to two year contested partition position in California.
- IRS does NOT use a consistent source for determining time discounts.
- Greater discounts are permitted for fractional LLP, LLC and Corporate interests than for tenants in common. Discounts up to 40% +- may be deemed very reasonable for such interests.

# Partition / Discounts

- A discount in excess of 25% for a fractional tenant in common, real property interest, is almost assured of an audit adjustment 'recommendation' or Notice of Proposed Adjustment (NOPA).
- A non partition clause will not likely eliminate an adjustment. Almost all TIC agreements also have arbitration clauses that can be argued to provide the same vehicle that partitioning does.

# Common Audit Adjustment Triggers

- The single most common problem is an understated FMV that is NOT ADEQUATELY supported by a qualified appraisal specific to that tax issue.
- “saving” hundreds to thousands of dollars on property appraisals, frequently results in hundreds of thousands of dollars...even millions in taxpayer loss due to the adjustment itself; interest and penalties.
- The place to save your client is NOT in appraisal fees.

# Common Loss Triggers - Continued

- Real estate appraisal is a profession specifically best performed by licensed / certified real estate appraisers.
- Probate referees are 'allowed' to value estates, but they are notoriously poor real estate appraisers. I've not seen a single probate referee prepared report for tax purposes that can withstand a critical technical review.

# Continued

- A business with real estate holdings is NOT valued the same way as the real estate that it holds. Confusion over this fact results in millions of dollars in adjustments, interest and penalties.
- BV practices are appropriate only to Business valuations. Real estate appraisal practices are applicable to real estate.

# A Final Thought

- Why would you ‘negotiate’ a settlement for your taxpayer client if, or when they are right?
- The prevailing thought or feeling among all IRS revenue agents is that 50% (or more) will be “given away” by appeals. With that in mind, why would you settle for ANY amount, that is more?
- Additionally, why would you settle when IRS has not even given you a copy of their valuation report?

# Closing - Continued

- While I encourage limiting deductions to those based on nothing more than the high or low end of a reasonable value range, derived from a proven qualified appraiser, sometimes your client simply can't resist the temptation to 'push'.
- IF your client has already 'pushed', I offer a critical formal review appraisal of their submitted appraisal(s) so that YOU will KNOW exactly where the vulnerability of their appraisal is, and its defensibility.
- Such services may legally be unbiased appraisals, OR advocacy position appraisal practice related services .