VALUATION FOR ESTATE AND GIFT TAXES:  
A PERSISTENTLY LITIGATED ISSUE

by

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As contrasted with the income tax, which taxes income determined over a period of time, the underpinning of the estate and gift tax is the determination of value at a point in time. More specifically, the estate and gift tax is based on the value of property owned at the time of death or, in the case of the gift tax, the value at the date of the gift.\(^2\) The only divergence from this tax structure is that, for purposes of the estate tax, an election may be made to value the property included in the gross estate at an alternate valuation date, which generally is six months after the decedent’s death.\(^2\)

The fact of the matter is that the present value of something depends not only on what it is currently worth but also on what it may be worth prospectively. Accordingly, informed speculation arguably is the standard for valuation. And where a dispute arises, expert testimony is essential. Often there seems to be a crystal ball aspect to valuation since the expert necessarily must peer into the future to a certain extent in determining value.

Since the estate tax that may be payable upon death, or the gift tax that may be payable at the time of the gift, is directly related to the value of the estate or the gift, proper valuation is a consistently litigated issue in the domain of estate and gift taxation. Some recent cases illuminate some of the issues in the continuing valuation saga in the estate and gift tax area.

1. DISCOUNT ISSUES

In Shepherd,\(^3\) a case filed in February, 2002, the Eleventh Circuit, affirming a decision of the U.S. Tax Court,\(^4\) expounded on some basic estate and gift tax concepts. Although the facts in Shepherd were not very complicated, the case demonstrates how a simple fact pattern can bring into play numerous legal concepts.

A. Salient Facts.

On August 1, 1991, J.C. Shepherd (the “taxpayer”) executed an agreement that established a family limited partnership. He was designated the managing partner with a 50% interest and each of his sons had a 25% interest. On the same date, he and his wife transferred 9,000 acres of land that they owned, which was subject to a long-term timber lease, to the partnership.

The Tax Court, however, factually determined that under Alabama law the partnership legally did not come into existence until August 2\(^{nd}\) since the partnership agreement was not signed by the taxpayer’s sons until that date. Accordingly, the Tax Court found, and the Circuit Court agreed, that the gift was not effective until August 2\(^{nd}\), which was after the partnership legally came into existence. Sequentially, therefore, the sons already held their partnership interests when the deed of land became effective. Because the creation of the partnership preceded the effectiveness of the deed, the sons’ interests in the land were acquired, indirectly, by virtue of their status as partners in the partnership. The taxpayer had also transferred some bank stock to his sons, but there was no dispute as to its valuation.

The taxpayer initially reported the transfers on his 1991 gift tax return as gifts of fractional interests in land to each son, with each receiving a 25% interest. He did not claim any discount on the gift tax return. Apparently there was an audit and the Internal Revenue Service (“IRS”) challenged the value reported by the taxpayer.

The Tax Court ultimately found that each gift of land was worth $160,876, applying a 15 % valuation discount because of the characteristics of the undivided fractional interests in land -- the lack of complete control over the parcel, the risk of disagreement about disposition of the land and the possibility of partition in the land.\(^5\)

Before trial in the Tax Court, the parties stipulated that the correct minority and marketability discount for a gift of a 25% interest in the family partnership was 33.5% if it were to be found that there was a gift of partnership interests rather than the land.

B. Issues.

The Eleventh Circuit determined that there were only two issues raised in the Tax Court that were worthy of its deliberations: (1) whether the gift was properly characterized as an indirect gift of interests in land as contrasted with gifts of partnership interests, and (2) whether a 33.5% discount is applicable when valuing the land in this type of scenario. As noted, the Tax Court, allowed only a 15% discount.

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The taxpayer asserted that what he intended was a gift of partnership interests rather than gifts of interests in land. The essence of his argument was that the Tax Court elevated form over substance in deciding that there was an indirect gift of land to the sons rather than a gift of partnership interests to them.

It should be noted that the taxpayer asserted he made a gift of partnership interests, as opposed to land, in order to get a higher discount. The reason for the higher discount for a partnership interest is beyond the scope of this paper. Basically, however, the higher discount is due to restrictions that appear in the partnership agreement, such as restrictions on disposing of the partnership interest and marketability difficulties that may pertain to a minority partnership interest. In any event, the government generally recognizes the distinction and, in this case, stipulated to a 33.5% discount if it were to be held that the transfers were those of partnership interests.

C. Circuit Court Analysis.

1. Indirect transfers. The Eleventh Circuit first observed that gifts to an entity, such as a corporation or partnership, by an owner of the entity are considered indirect gifts to the other owners of the entity in proportion to their interests. In the case at bar, the Circuit Court agreed with the Tax Court that rather than completing a gift to a pre-existing partnership followed by a gift of partnership interests to his sons, the taxpayer created a partnership in which his sons had existing interests and then transferred the land to it. Accordingly, under the indirect gift doctrine, there was a gift of land to the sons and not gifts of partnership interests.

2. Form over substance. The Circuit Court noted that the argument of the taxpayer claiming he intended a gift of partnership interests ignored the fact that on his gift tax return he reported the transfers as gifts of land. Here, the Court significantly pointed out the “crucial import of facts in both tax planning and the adjudication of tax disputes,” and the importance of recognizing that “a transaction must be given its effect in accord with what actually occurred and not in accord with what might have occurred.” Finally, the Court observed that taxpayers must accept their choice and not speculate how things might have turned out if the transaction were recast. Thus, the Circuit Court adhered to the form of the transaction despite the taxpayer’s assertion that the substance was different.

3. Valuation. Since the Eleventh Circuit determined that the Tax Court correctly found there were gifts of land – and not partnership interests – it then focused on whether the Tax Court correctly valued the gifts, and found that it did. The correct rule is that the value of the gift is measured by the value of the gift at the time it passes. There is a brief “moment of truth” at which “the court must pinpoint its valuation at this instant.”

The correct focus is to look at the property being transferred as if one were in the shoes of a “potential purchaser at that time.”

The Circuit Court pointed out that the value for gift tax purposes does not depend on whether the donee holds the gift in “partnership, fee simple … a trust or any other method for holding property by a donee.” Valuation cannot be determined by the value of the interest that ceases or the value of the interest that begins.

Despite its mention of a hypothetical moment at which valuation should take place, the Circuit Court stated that a potential buyer would discount the value because of events that might occur in the future that could impact value, such as, partition, inability to sell and lack of control. But the Court pointedly repeated that no consideration should be given to future events related to who was receiving the property and how it was to be held.

4. Conclusion. In conclusion, the Circuit Court agreed with the Tax Court’s application of a 15% discount, which was actually based upon testimony of the taxpayer’s expert.

The Shepherd case is an important primer for practitioners by illustrating that the sequence in which events take place can be critical to the tax outcome. If the transaction is not properly structured, it most likely will not be possible after the fact to assert that the tax consequences would have been different – and more favorable – if the transaction had been done in a different way. In Shepherd, the higher 33.5% discount would apparently have pertained had the gift been made to the family partnership first and then partnership interests gifted.

The Shepherd case also brings into play the concept of an indirect gift. A gift to an entity by one of the owners of the entity is considered indirectly a gift to others who have a stake in the entity.

Finally, the case expounds on the specific point in time that a valuation decision should be made. It is the point in time of the passage of the property, and not how it was held by the transferor or will be held by the transferee.

5. IRS Technical Analysis. Subsequent to the Shepherd decision, in November 2001, the I.R.S. issued a Technical Advice Memorandum (“TAM”) affirming the indirect gift concept, and reiterating that valuation is based upon the value of property passing and not on the value received by the donee. The TAM, citing Shepherd and a number of other cases, rejects the argument that a gift to an entity should be categorized as an enhancement of the interests of others in the entity (e.g., the partnership interests of the sons in Shepherd) and valued accordingly. The gift discussed in the TAM, however, was not of land, but of municipal bonds. With respect to an indirect gift of marketable securities, the TAM concludes that the valuation of marketable securities should be based upon their full fair market value with no discount.
II. APPLICATION OF AGGREGATION THEORY

In the estate and gift tax sphere, much planning revolves around stratagems for obtaining valuation discounts on the transfer of property, either during lifetime or at death. In general, the procedure used to obtain a discount is to transfer a fractional part of the property or to die owning a fractional part. The discounts that have gained credibility are: lack of marketability, lack of control (minority interest), blockage (the inherent difficulty of selling large block of stock in one fell swoop), transferability restrictions, discount for dependency on a key person and, more recently, a discount for built in capital gains tax. Although the IRS seems reluctantly to have accepted the concept of discounting, it has from time-to-time attempted to limit its applicability by claiming that separate interests should be aggregated in determining value. After losing numerous court battles, the IRS seems to have conceded that family attribution is not relevant in the estate and gift tax domain. But despite conceding on family attribution, the IRS has not given up on the aggregation theory despite a major loss in 1999 in Estate of Mellinger. The applicability of the aggregation theory was recently highlighted in Fontana, a case decided by the United States Tax Court in March of 2002.

A. Salient Facts.

In Fontana, the decedent, Aldo Fontana, and his wife, Doris Fontana, owned 100% of the stock of a closely held company, Fontana Ledyard Co. (“Ledyard”) as community property. Doris, who predeceased, left her stock in Ledyard by will to two trusts, Trust A and Trust B. Aldo was trustee of both trusts. The ultimate beneficiaries of the trusts were the two children of Aldo and Doris. During his lifetime, Aldo received from both of the trusts all income and such principal as was necessary for his proper support, care, maintenance, and education. This power to invade principal for his own benefit was not a general power of appointment since it was exercisable only in a fiduciary capacity. Aldo, however, also had a testamentary general power of appointment over the assets held by Trust A. As a result of this general power of appointment, the assets in Trust A qualified for a marital deduction in the estate of Doris. The general power of appointment basically gave Aldo the authority to dispose of the principal and undistributed income of Trust A to anyone (in trust or otherwise) including his own estate.

When Aldo subsequently died, he owned 50% of the stock of Ledyard and Trust A held about 44%. He had exercised the testamentary general power of appointment dividing Trust A into two separate trusts, one for each of his two children. The assets in Trust B also went to the two children by the terms of Doris’ will. Additionally, Aldo bequeathed his 50% in trust to the two children.

An estate tax return was filed for Aldo that included the 50% of Ledyard that he owned in his own name and also the 44% of Ledyard that was owned by Trust A. The estate, however, valued each block of stock separately. Apparently based upon discounts for lack of control and marketability – each block separately was not a controlling interest – the estate reported the 50% interest at a value of $2,043,500 and the 44% interest at a value of $1,747,500.

The IRS, however, determined that the both blocks should be aggregated and valued as a 94% controlling interest. On this basis, the value was determined to be $4,850,000, or $1,059,000 overall higher than a valuation based upon two separate blocks.

B. Issue.

The foregoing values apparently were not in dispute since the matter was submitted to the Tax Court fully stipulated. Thus, the issue before the Tax Court was whether the two blocks of stock should be aggregated for purposes of valuation or considered two separate blocks for such purpose.

The primary contention of the estate was that the Tax Court’s holding in Mellinger should be extended to prevent aggregation of stock owned outright with stock subject to a general power of appointment.

C. Tax Court Analysis.

1. Estate of Mellinger. The facts in Mellinger were fairly complex. The substance of the situation, however, was that Frederick Mellinger’s will created a qualified terminable interest property (“QTIP”) trust for the benefit of his wife, Harriett, with stock that he owned in Fredericks of Hollywood. Harriett also owned stock in Fredericks of Hollywood.

Upon Harriett’s subsequent death, the IRS sought to aggregate for valuation purposes the stock owned by Harriett individually with the stock in the QTIP trust established for her benefit under her husband’s will. As discussed hereafter, the stock in the QTIP trust was includable in Harriett’s gross estate. Each separate interest (about 28%) was not a controlling interest and as such each interest would qualify for a discount. But if aggregated, the interests were a controlling interest (about 56%) and would not qualify for a discount. The Tax Court concluded that there should not be aggregation and allowed a 25% valuation discount as to each interest.
2. *Qualified Terminable Interest Property.* For estate tax purposes, there is an unlimited deduction for a property interest passing to a surviving spouse. However, the deduction is generally disallowed if the property interest is terminable—that is, it will terminate or fail on lapse of time or the occurrence or failure of an event or contingency. Even a life interest for a surviving spouse is a terminable interest since the interest terminates on lapse of time. An important exception, however, applies to Qualified Terminable Interest Property ("QTIP"). A marital deduction will be allowed for a QTIP transfer even though the surviving spouse receives only an income interest for life and has no control over the ultimate disposition of the property. Typically, though not necessarily, a QTIP transfer is to a trust for the benefit of the surviving spouse.

The basic requirement for a property transfer to qualify as a QTIP transfer—and hence for the marital deduction—are: (1) the property must come from the decedent, (2) the surviving spouse must have a qualifying income interest for life, and (3) an election must be made by the executor to treat the property transfer as a QTIP transfer.

A surviving spouse has a *qualifying income interest* if he/she is entitled to all the income from the property payable at least annually, and no person has a power to appoint any part of the property to any person other than the surviving spouse during his/her lifetime.

The concept underlying the QTIP provisions is to permit a decedent to benefit his/her surviving spouse with income from property during lifetime yet ultimately controlling the disposition of the property. A typical situation where a QTIP transfer might be made is where there is a second spouse and children from the first marriage. The second spouse could get the income during lifetime—a terminable interest—and after death the property could go to the children. Prior to the enactment of the QTIP provisions in 1982, the marital deduction was permitted only for property transferred outright to the surviving spouse or in certain specified forms that gave the surviving spouse control over the transferred property.

The trade off for allowing a marital deduction for a QTIP terminable interest is that the value of the QTIP property transfer is includable in the estate of the surviving spouse, determined as of the date of the death of the surviving spouse.

The *Mellinger* case involved stock in a corporation. However, in a case decided at about the same time as *Mellinger,* the Tax Court applied the same rationale with respect to a partnership interest held in a QTIP trust that was established for the benefit of a decedent and a partnership interest in the same partnership held by a revocable trust that was under the control of the decedent. Each interest was a minority interest, but combined a controlling interest. Although both interests were includable in the gross estate of the decedent, they were not aggregated for purposes of valuation.

3. *General Power of Appointment Trust.* In addition to a QTIP trust, another type of trust in which a surviving spouse has only a lifetime interest, and yet will qualify for the marital deduction, is a trust as to which the surviving spouse has a general power of appointment. Property over which a decedent at the time of death has a general power of appointment is included in his/her estate.

As the Court noted, “Historically, a GPA has been equated with outright ownership of the property because the holder of the power (i.e., the decedent) can appoint the property to his estate and, thus, dispose of it as his or her own.”

4. *QTIP Trust Contrasted with a General Power of Appointment Trust.* In conclusion, the Court contrasted the inclusion of property included in a decedent’s gross estate under the QTIP provisions with inclusion under the general power of appointment provisions. In the QTIP situation, as illustrated in *Mellinger,* the property included in the surviving spouse’s gross estate does not actually pass from him/her, and the surviving spouse does not control its disposition. On the contrary, in the instant case, Aldo, who possessed a general power of appointment, had the power “to control the ultimate disposition of the stock.” Accordingly at death, the “critical moment for estate tax valuation purposes,” he controlled the “disposition over the property.”

Thus, the Court concluded that the Ledyard stock owned individually by Aldo had to be aggregated with the stock in the trust subject to the general power of appointment.

III. VALUING CLOSELY HELD STOCK

A lengthy, detailed, but excellent, opinion regarding the valuation of stock in a closely held corporation was rendered by the Sixth Circuit in *Gross and Linnemann* in November of 2001, affirming an equally lengthy and detailed decision of the United States Tax Court.

A. *Salient Facts.*

The Gross and Linnemann families directly and through voting trusts owned all of the stock of a major Pepsi-Cola bottling company (“G&J”). The company had made an election to be taxed as a small business corporation (“S corporation”). In 1992, Walter Gross gave each of his three children 124.5 shares in G&J. Patricia Linnemann gave each of her two children 187.5 shares. The gifts to each child represented less than one percent of the outstanding stock of G&J. Walter Gross and his wife, Barbara, each reported one-half of the asserted value on a timely filed gift tax return and Patricia Linnemann and her husband, Calvin, did likewise.

An appraisal report prepared by an appraisal firm retained by the taxpayers valued the stock at $5.160 per share. Thus, the Grosses reported a gift of $2,121,480 and the Linnemanns a gift of $2,130,000. In a notice of deficiency, the IRS valued the stock at $11,738 per share, but later agreed that it was worth no more than $10,190 per share. After trial, during which there
was detailed testimony by the expert for the taxpayers and the expert for the I.R.S, the Tax Court agreed with the I.R.S. valuation. The taxpayers appealed to the Sixth Circuit Court of Appeals.

B. Major Issues.

The taxpayers raised various issues on appeal. The foremost matters considered by the Circuit Court and its determinations may be summarized as follows:

1. Admissibility of Evidence. The taxpayers initially challenged the admission of the testimony of the I.R.S.’s expert witness. But the Circuit Court stated that the trial court has broad discretion in deciding how to test an expert’s reliability. A preliminary evaluation of the expert’s testimony must be made before admitting it considering: (1) whether a theory has been or can be tested, (2) whether the theory has been subject to peer review and publication, (3) the known or potential rate of error, and (4) whether the technique has been accepted by the scientific community. The Court observed, however, that these guidelines are not a “straightjacket” and the trial court has broad latitude in determining whether an expert’s testimony is relevant. After considering the credentials and testimony of the I.R.S expert in detail, the Court found that the Tax Court did not err in admitting his testimony.\(^4\) Moreover, the Court noted, the I.R.S. determination of a deficiency is presumptively correct.\(^4\)

2. Discounted Cash Flow. Both the taxpayers’ expert and the I.R.S expert utilized a discounted cash flow analysis in valuing the corporation’s stock. The Court noted that this is a “reliable tool for financial analysis.”\(^4\)

3. Tax Affecting. In doing his analysis, the I.R.S. expert did not consider tax effect since G&J was an S corporation, which generally is not subject to taxation. However, testimony was introduced that, at the relevant time, a tax effect using a 40% rate was customarily considered – although not all agreed – in valuing an S corporation despite the fact that it generally is not subject to taxation. The rationale behind considering tax affect for an S corporation was that S corporation shareholders were at risk that the corporation might not distribute enough income to shareholders to cover their tax obligations and that this cost must be considered.\(^4\) Moreover, testimony was also introduced in the Tax Court that the I.R.S. Examination Technique Handbook at the time endorsed tax affecting in valuing an S corporation. However, the Circuit Court agreed with the Tax Court’s rejection of the notion that tax affecting should be considered to cover the possibility that G&J might not distribute enough income to cover its shareholders liabilities. Accordingly, it found that the I.R.S. expert was correct in not considering tax affecting whatsoever in his valuation.

4. Marketability Discount. Since G&J was a closely-held corporation, it was agreed that there should be a marketability discount. The issue, however, was whether the discount should be 35%, as proposed by the taxpayers’ expert, or 25%, as proposed by the I.R.S.’s expert. Interestingly, the taxpayers’ expert was from an appraisal firm that specialized in business valuations whereas the I.R.S. expert, who held a doctorate, took a more scholarly and academic approach. The taxpayers’ expert relied to a certain extent on summary information. In contrast, the I.R.S. expert “conducted his own independent analysis and, rather than simply applying the average discounts listed in those studies, analyzed G&J specifically to determine the proper lack of marketability discount.”\(^4\)

Accordingly, the Circuit Court found no problem with the Tax Court’s finding that the I.R.S. expert’s testimony regarding the marketability discount “thorough and more persuasive” and that the “tax court’s application of a 25% discount was not clearly erroneous.”\(^4\)

IV. SOME OBSERVATIONS

The lesson to be learned from the Shepherd case is to that when engaging in tax planning it is important to do things in the right sequence. Although the I.R.S often successfully raises the argument of *substance over form* in challenging the machinations of taxpayers, a taxpayer will no doubt fail in asserting this argument in reverse in trying to dispute what the taxpayer has in fact done. Accordingly, the taxpayer’s argument that the I.R.S. elevated form over substance did not hold up since it was the taxpayer who was responsible for the form.

The Fontana case points out that the I.R.S aggregation theory, although not applicable in a family framework and further limited by the Mellinger decision, is still alive and well and may be applicable in the right context.

Finally, the message of the Gross case is that when engaging in a *battle of the experts* one should be careful and understand that the *truth is in the details*. The courts will engage in a thorough review of the background of the expert and the factual and theoretical underpinnings of his/her testimony. As pointed out, greater credence will be given to the testimony of the expert who hones in on the specific company being evaluated rather than relying on abstract statistics. When expert testimony is being evaluated, the taxpayer is at a decided disadvantage since an I.R.S. determination is presumptively correct. Accordingly, the I.R.S expert starts off with at least some advantage that the taxpayer has to overcome.

Both experts in Gross were apparently found competent by the Tax Court and the Circuit Court. The I.R.S. expert, however, was given the edge, which points out the difficulty facing practitioners when the outcome of a matter depends on expert testimony. As the Circuit Court pointed out, “Overall, the entire valuation process is a fiction – the purpose of which
is to determine the price that the stock would change hands from a willing buyer and a willing seller. However, a court is not required to presume hypothetical, unlikely, or unreasonable facts, in determining fair market value.”

Footnotes

1. I.R.C. §§ 2031 and 2512. All references to “I.R.C.” are to the Internal Revenue Code of 1986, as amended to date.
2. I.R.C. § 2032. In the case of property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent’s death such property shall be valued as of the date of sale, exchange, or other disposition (I.R.C. § 2032(a)(1)). An election to use the alternate valuation date can only be made if it would decrease both the gross estate and the estate tax (I.R.C. § 2032(c)).
10. Id. at *7-8, citing Robinette v. Helvering, 318 U.S. 184,186 and Reg. § 25.2511-2(a) (1999).
11. Id. at *8, citing United States v. Land, 303 F.2d 170, 172 (5th Cir. 1962).
12. Id., citing United States v. Land at 173, and Reg. § 20.2031-1(b) (1965) defining value 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 a reasonable knowledge of the relevant facts.”
13. Id. at *8.
15. Id. at *11.
16. The Court noted that although the cases cited by it involved the estate tax, they were also relevant to the gift tax because the two taxes “are construed in pari materia since the purpose of the gift tax is to complement the estate tax by preventing tax-free depletion of the transferor’s estate during his lifetime.” Shepherd v. Commissioner, 2002 U.S. App. LEXIS 3165, note 7 (11th Cir. 2002), citing Harris v. Commissioner, 340 U.S. 106, 107 (1950).
23. See I.R.C. § 2514(c)(1).
25. The 50% owned by Aldo was clearly includable in his gross estate, pursuant to I.R.C. § 2033, since it was property owned at death, and the stock in Trust A was includable pursuant to §2041, which requires the inclusion of property in the gross estate with respect to which the decedent held at the time of his death a general power of appointment.
27. Id. at 38; accord Estate of Bonner v. United States, 84 F.3d 196, 198 (5th Cir. 1996).
29. I.R.C. § 2056(b).
34. I.R.C. § 2044.
35. See I.R.C. §§ 2038 and 2044.
37. I.R.C. § 2056(b)(5). A general power of appointment is defined as a power exercisable by a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate. I.R.C. § 2041(b)(1).
38. I.R.C. § 2041(a).


I.R.C. §§ 1361-1379.

See I.R.C. §2513.


Id. at *35.

Id. at *48-49.

Id. at *49.

Id. at *66.