

For a limited time

The ability to recognize opportunity in a recessionary environment is instrumental for effective wealth management and tax planning.

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Article Summary

While the current economic environment has many investors reeling, opportunities for those seeking to shield wealth from tax liabilities are far from gone.

Combined with favorable gift and estate tax laws, depressed asset values can mitigate the tax liabilities associated with gifting or transferring wealth. But for how long?

Given the current recessionary environment, actively managing wealth and practical tax planning can be more essential than ever. A core technique utilized in tax planning revolves around the practice of gifting or transferring an ownership interest to another family member using the value of an asset at a specific point in time.

As such, the current economic environment has created an opportunity such that depressed asset values allow transfers to be made at deeply reduced values. In addition, the existing tax law regarding the discounting of transferred interests is favorable for entities holding marketable securities and other non-operating assets such as real estate. However, time to capitalize on the current economic environment and favorable tax law will not last forever; in fact time may already be running out.

Recognizing Opportunity

The economic impact on interest transfers is most evident when dealing with entities holding substantial marketable securities. Since reaching an all time high of 14,164 in 2008, the Dow Jones Industrial Average ("Dow") has experienced a major decline due to a recessionary economy primarily attributed to the collapsed real estate and financial markets.

At the low point, the Dow had lost nearly 54.0 percent of its total value before rebounding to approximately 8,500 or roughly 40.0 percent below the high seen in the second quarter of 2008.

While the changes in the Dow are not indicative of every financial market or security, it is the oldest and single most

watched market index in the world. Therefore, using the Dow as a benchmark, we will assume the hypothetical entity is entirely invested in marketable securities that mirrored the fluctuations in the Dow.

To illustrate the impact on the gift or transfer of an ownership interest, we will examine a hypothetical transfer using two time periods corresponding to the two points in the Dow mentioned above. The table below illustrates the results of a 10.0 percent interest transfer for each time period, assuming the same securities are held at both dates.

<i>Hypothetical Interest Transfer</i>	Market Value Balance Sheet	Market Value Balance Sheet
Assets		
Dow Index	14,164	8,500
Approximate decrease in Dow index	-	- 40.0%
Marketable securities held	\$ 50,000,000	\$ 30,000,000
Value of 10.0% interest	<u>\$ 5,000,000</u>	<u>\$ 3,000,000</u>
Estimated tax rate	45.0%	45.0%
Total tax liability	<u>\$ 2,250,000</u>	<u>\$ 1,350,000</u>

As the table shows, the effect of the market downturn can substantially reduce the tax liability of a gift or transfer of an ownership interest. Due to the recent collapse of real estate markets nationwide, entities primarily comprised of real estate also have a similar opportunity. During the years preceding the current economic downturn, the real estate markets benefited from strong

appreciation in property value and increased return on investment. However, the collapse of the housing market due to the subprime mortgage meltdown resulted in a significant market correction in the real estate markets. According to the National Association of Real Estate Investment Trusts (“NAREIT”), total return on REIT’s in 2008 was negative (37.3) percent.

Capitalizing on Favorable Tax Policy

In addition to capitalizing on depressed market values, the most crucial rationale for taking immediate action is the result of a potential change in regulation governing transfers. Discounting the value of interests in family-controlled non-business entities upon transfer to another family member is a standard technique of estate and gift tax planning.

The discounts arise from the concepts of lack of control and lack of marketability for the interest being transferred. The lack of control discount is applied due to the fact that a third party buyer would not pay the pro-rata value of the underlying interest without the elements of control that would enable them to liquidate their position or control cash flows and operations.

The discount for lack of marketability stems from the concept that a third party buyer of a family partnership or similar interest would be difficult to find because

the interest is not liquid or actively traded. As such, it is not uncommon for valuation professionals to apply total discounts upwards of 35.0 to 40.0 percent to non-controlling, non-marketable interests. However, changes introduced in the United States House of Representatives seek to eliminate certain discounts.

Understand the Impact of Policy Change

The proposal in H.R. 436, introduced January 9, 2009 with an effective date of December 31, 2009, would eliminate valuation discounts for lack of marketability and lack of control (minority discounts) in valuing an interest in an entity for estate and gift tax purposes unless the interest is actively traded. Actively traded is not defined within the bill but references are made to section 1092 which defines the term as “property for which there is an established financial market.” This would imply things such as bonds or publicly traded stock on an active exchange.²

Therefore, the discount for lack of marketability is eliminated if the non-actively traded business does not carry on a trade or business. If it carries on a trade or business but also has non-business assets, those assets will be removed from the valuation of the entity and valued without discount. A lack of marketability discount may still be applied for the valuation of the entity as a whole after taking out non-business assets.

¹ A real estate investment trust, or REIT, is a company that owns, and in most cases, operates income-producing real estate. Some REITs also engage in financing real estate. The shares of many REITs are traded on major stock exchanges.

² Certain Estate Tax Relief Act of 2009 (Introduced in House) H.R. 436, www.gpo.gov/fdsys/pkg/BILLS-111hr436IH/pdf/BILLS-111hr436IH.pdf

However, depending on the nature of the entity the change in regulation could result in a substantial difference in the overall value of the interest. Using the hypothetical interest transfer discussed above, the table below illustrates the impact of eliminating a marketability discount on the transfer of an ownership interest.

<i>Hypothetical Interest Transfer</i>	Market Value Balance Sheet	Market Value Balance Sheet
Assets		
Dow Index	14,164	8,500
Approximate decrease in Dow index	-	- 40.0%
Marketable securities held	\$ 50,000,000	\$ 30,000,000
Value of 10.0% interest	<u>\$ 5,000,000</u>	<u>\$ 3,000,000</u>
Discount for Lack of Marketability	0.0%	24.0%
Non-marketable FMV of 10.0% interest	5,000,000	1,267,500
Estimated tax rate	45.0%	45.0%
Total tax liability	<u>\$ 2,250,000</u>	<u>\$ 570,375</u>

As shown, if a practitioner were not permitted to apply a discount for lack of marketability to the underlying securities held by the entity, the result would be a much higher tax liability for the transfer of the interest.

Additionally, lack of control discounts will not be allowed in the valuation of a non-actively traded business if the taxpayer (through attribution rules) owns or controls

more than 50.0 percent of the entity, regardless of whether or not the entity carries on a trade or business.

Time May Be Running Out

Eliminating the application of discounts in certain circumstances may result in ownership interests being overvalued compared to what would be received if the interest were sold on the open market. As a result, the value of an interest in an entity for estate and gift tax purposes could be greater than the value of the interest if it were publicly sold on the open market.

As December 31, 2009 approaches, the uncertainty surrounding the rebound of the economy is extremely high, but one thing is clear, there is more pressure than ever from the IRS to prohibit the future use of discounts for lack of control and lack of marketability.

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