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Special Tax Edition

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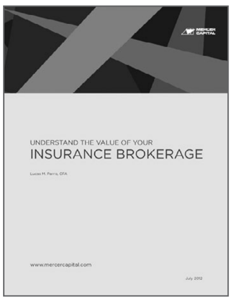

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The 2012 Gifting Opportunity

Don't Let the Logjam Affect Your Clients

by Z. Christopher Mercer, ASA, CFA, ABAR

During the 2012 calendar year, individuals can gift, or give away, as much as $5.12 million and pay no federal gift taxes on the gifts, although this amount is reduced by the amount of any taxable gifts made in prior years. In the absence of a Congressional change in the law, however, the gift tax exemption will be reduced to $1 million on January 1, 2013.

Most advisors have already begun planning with clients and currently there is an expected crush of planning that will take place at year-end.

Per an article on www.cnbc.com:

> "The joke among attorneys is that no one's planning a vacation for the last quarter," says Scott Farber, a wealth strategist with U.S. Trust in Miami. "We anticipate being inundated by last-minute planning, and it could become a real problem. When everyone's getting it done at once, it'll be one big logjam." (Get Ahead of the Coming Gift-Tax-Apalooza: June 8, 2012, www.cnbc.com)

This article provides additional background and perspective about the 2012 gifting opportunity for individuals, couples, and smaller estates, as well as advice on timing. Perspective is provided on this gifting opportunity from three leading estate planning attorneys:

» **Charles A. (Clary) Redd** of Stinson Morrison Hecker, LLP. Redd wrote an article titled "The Perfect Storm" in the January 2012 issue of *Trust & Estates*.

» **Bryan Howard** of Howard & Mobley, PLLC. Howard is the author of the blog *Tennessee Estate Planning Law*. Over the past several months, he has written a series of posts on "The Great 2012 Gifting Opportunity." www.tennesseeestateplanninglaw.com.

» **Harris H. (Trip) Barnes, III** of the Barnes Law Firm, P.A. Barnes wrote a letter to his clients in February 2012 talking about what to consider on the gifting and estate planning front for the remainder of 2012. He has given us permission to excerpt from that letter.

The Perfect Storm

Clary Redd's article describes the current environment as a "perfect storm" for clients who may want to take advantage of the current situation to achieve "thunderous" results. Redd is careful to state that he rarely uses such superlatives in his writing and reads their use by others with skepticism. However, he highlights the elements of this perfect storm:

1. **High Applicable Exclusion Amount.** As noted above, the gift tax applicable exclusion amount and the generation-skipping transfer (GST) exemption are both $5.12 million for an individual and double that for a married couple. Absent a conscious change by Congress, these amounts drop to $1 million at the stoke of midnight December 31, 2012. The current exemption amount has never been higher.

2. **Low Marginal Estate and Gift Tax Rate.** The current rate is 35%, which many believe is as low as will be seen for the foreseeable future. Any increase in the marginal rate will increase the cost and reduce the attractiveness of many gift and estate planning techniques.

3. **Extremely Low AFRs.** The long-term AFR (annual basis) has risen from 2.60% in January 2012 to 2.89% in May 2012. Recent months have seen rates quite low relative to historical levels.

4. **Depressed Asset Values.** While Redd's article did not anticipate the strong start to the year seen in the stock markets, many stocks and assets in other classes remain depressed in value relative to historical levels.

5. **Defined Value Clauses.** Redd suggests that now is a great time for charitably inclined folks holding hard-to-value assets to make gifts and sales of the property. In doing so, a stated dollar amount would be allocated to a trust for the benefit of descendants, with the remainder being allocated to charity. He notes that this technique has been upheld in several courts, but that the IRS may promulgate contrary rules in the future.

6. **Valuation Discounts.** Taxpayers have been giving nonvoting minority interests and voting minority interests in businesses for many years, taking advantage of allowable minority interest (if applicable) and marketability discounts. Other taxpayers have placed such assets into FLPs (or LLCs or other asset holding entities) and achieved reasonable discounts at the level of the holding company, as well. Redd warns about insuring proper business reasons for formation of such entities. From our experience, it is also necessary and appropriate to run them as businesses to avoid many other issues related to Section 2703.

7. **Very Long Trusts.** Per Redd: "It is legally permissible in many states to establish trusts that are designed to exist longer than permitted under the common law rule against perpetuities." Be sure to talk to an experienced planner about these trusts.

8. **Grantor Trusts.** Read Redd's article to learn about a twist enabling individuals to set up trusts where the value of the trust's assets will not be includable in the estate and all income and expense items belong to the grantor. Again, this is an area where expert planning advice is essential.

Are Your Client's Ready, or Even Able, to Benefit from the Great 2012 Gifting Opportunity?

Bryan Howard discusses some of the same issues, but from a different viewpoint. While Redd talks about the "perfect storm" that exists in some detail, Howard assumes that the benefits of doing something should be apparent to most. He poses several questions in discussions with clients as they talk about what actions to take during the remainder of 2012. These questions put the decision-making process into human terms and are quite instructive. A few of Howard's posts deal with issues specific to Tennessee residents; however, the entire series has broad appeal.

1. Can you afford to make the gift? Said differently, is there a chance that you will run out of money if you make the gift?

2. Are you prepared to pay [state] gift taxes? There are several ways to make gifts without paying Tennessee gift taxes; however, these techniques are often impractical.

3. What impact will the gift have on your children?

4. What assets should be given?

5. Are you willing to give up control of the assets you are transferring?

6. Should you transfer "discounted" assets such as fractional interests in real estate or interests in corporations, LLCs, or limited partnerships?

7. Should you make the gift to a trust rather than directly to the recipient? Most of our clients have decided to use a trust.

8. If you use a trust, what are the provisions regarding trustees and distributions?

9. If you use a trust, should you allocate generation-skipping transfer tax exemption to the trust? The answer is usually yes.

10. How will the gift impact your overall estate plan?

11. When should the gift be made?

> Like many estate planners, we are already seeing a major uptick in our gifting assignments, as are our valuation colleagues. Acting now assures there will be sufficient high-quality appraisal expertise available to accomplish your objectives in a timely manner.

The Dirty Little Secret for Smaller Estates

In a letter to clients earlier in the year, Trip Barnes made some of the same points about the obvious benefit of the high current exemption.

While Redd and Howard have focused on individuals and couples who have the ability to make large gifts, Barnes discusses issues that relate to smaller estates. The following is of particular note:

> "What sort of wills should be 'drafted'? Currently, if you have an estate that between husband and wife exceeds $5 million you could have an estate tax problem. (Wait — I thought the combined exemption was $10 million — read on).
>
> You say, if I have $3 million and my spouse has $3 million that is only $6 million, and the total exemptions are $10 million; thus no estate tax. This is true.
>
> However, the dirty little secret is at death of the first spouse, you must file a Form 706 (Estate Tax Return) to transport the exemption from the first spouse to the second spouse. If you don't do this, you lose it.
>
> Thus, the question is how many people are going to go through the time and expense of hiring lawyers, and appraisers to appraise properties, review those properties, and then create an estate tax return? I predict not that many, and thus, the exemption will be lost.
>
> Finally, if the surviving spouse remarries, and the spouse to whom he/she is currently married at death has used up his or her exemption, then the exemption of the first spouse did not transport.
>
> Thus, there are lots of reasons to still use the traditional estate planning and the credit shelter trust/by-pass trust to capture the exemption amount and to negate the need of a Form 706. (Even in estates of less than $10 million fair market value.)
>
> One other hazard to consider is that if you are filing a Form 706 you are now giving some IRS estate tax examiner the opportunity to review your 706. He or she may disagree with your value, thus, you could easily find yourself with a 706 showing an amount less than $5 million increased to amounts substantially more than $5 million and potentially generating estate tax. (Thus, the need for really good appraisals!)
>
> Thus, the law is not quite as benign as one would think and is certainly not as 'user-friendly' as one would think."

Will Your Clients Have the Resources Available to Them When They Need Them?

There is truly a great gifting opportunity in 2012. As Redd states, there is a perfect storm for such gifting. However, taxpayers and planners need to be careful of the dirty little secret about smaller estates and protect themselves or their clients.

If your clients are considering making a substantial gift this year, act now.

Like many estate planners, we are already seeing a major uptick in our gifting assignments, as are our valuation colleagues. Acting now assures there will be sufficient high-quality appraisal expertise available to accomplish your objectives in a timely manner.

When seeking high quality valuation expertise, contact the professionals of Mercer Capital. We have the expertise, experience, and, unlike most valuation service providers, we have the depth of resources as one of the largest independent valuation firms in the country to help you both now and later in the year.

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You will have a proposal of services within 48 hours. Complete confidentiality assured.

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Gift, Estate, & Income Tax Compliance Services

- Family wealth planning, including gift and estate tax compliance
- Corporate tax planning
- Valuation of interests in family limited partnerships and limited liability companies
- Valuation of preferred stock, trust preferred securities, and other non-equity instruments
- Intangible asset valuation

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What Estate Planners Can Do To Assure Their Clients Obtain Valuation Services in the 2012 Gifting Opportunity

Q&A with Tim Lee

In this Q&A, we interview Timothy R. Lee, ASA, Managing Director of Mercer Capital's Corporate Valuation Practice.

Tim has over 18 years of experience valuing companies and asset holding entities of all sizes.

In addition, he is the author of A Reviewer's Handbook to Business Valuation.

Is Mercer Capital currently seeing an uptick in estate planning valuation engagements?

Most definitely. The uncertainties concerning impending changes to gift and estate tax laws are driving increased interest and action. Additionally, impending change in the capital gains rate and uncertainty concerning valuation discounts and certain trust vehicles (among numerous other considerations) is prompting clients to study their strategic postures regarding business and personal assets and to take action. The multi-faceted opportunity that is 2012's tax code could easily become tomorrow's sour grapes. A message to our legacy and prospective clients; sooner is better than later, as the calendar for most appraisers (both real estate and business) threatens to be jammed with a rush of project activity. We expect this surge of activity to extend well into 2013 as some clients denominate their gifts in dollars terms with follow-on work to specify the percentage interest gifted.

What types of gifts are you currently seeing your clients make?

The unique combination of tax concerns is making the current situation an equal opportunity occasion for all asset types — passive and operating, large and small. We are seeing gifting activities with mature FLPs we last valued 5, 10, or 15 years ago as well as LLC formations to harbor a new generation of family assets and wealth. We are also seeing significant use of various trust mechanisms due to historically low AFRs and the prevailing advantageous valuation trends in many business industries. Mercer Capital offers the gamut of services to its clients, including efficient fees for the valuation of partnership and LLC interests, as well as the most comprehensive services for complex entities and business models.

What do estate planners need to do or know to get their clients ready for the valuation process?

As estate planners are already doing, have the discussion to create client awareness to allow for the valuation process to get properly executed. Defining an engagement sooner rather than later requires the gathering of recent financial information and making sure that all entity documentation is in order (buy-sell agreements, entity operating agreements, ownership lists, etc.). Nothing alerts a business appraiser better than coming to the table with a full five years of financial statements and tax returns. If we have valued the entity in the past, compiling an updated status report using the descriptive narrative in the prior valuation can streamline process and timing. For estate planners: compile your prospect pool, contact your valuation providers, and map the process and work product for each client in time.

Do you expect a large demand for valuation services in the 2nd half of 2012 from clients taking advantage of the $5.1 million personal exemption?

In fact, demand materialized in early 2012. The current atmosphere and the laws of human nature (procrastination) suggest that late 2012 activity will be robust and will threaten the capacity of tax attorneys and business appraisers to deliver workable timing and solutions.

Is Mercer Capital prepared for such a demand?

Yes. And, we can't emphasize the immediate need to make a plan now and work it. Get the engagement process settled and plan for information collection and timing. Increasingly we are valuing businesses and assets now to establish a platform for the model and the report in order to update the analysis for a gift or sale later in the year. As a 40-person valuation firm, we are not limited by the professional and data scarcities of smaller, less experienced practices. Additionally, our quality control disciplines are designed to minimize common mistakes in both process and analysis, which are more apt to occur in situations where demand for service is high.

What advice would you give to estate planners and their clients now if a valuation is needed?

Call us now, finalize the engagement plan, and collect the pertinent information. The sooner we know your need, the sooner we can help with project design and timing. In our experience, many planners often struggle with igniting client participation – for the balance of 2012 this is simply not acceptable as inaction and tardiness could result in under-achieving the opportunities on stage for 2012. Increase your options and avoid the glut by acting as soon as possible.

Tax Compliance Valuation Services

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Tax Court Case Update

Wimmer v. Commissioner

A Present Interest Victory for the Taxpayer

Case Citation

Estate of George H. Wimmer v. Commissioner, T.C. Memo 2012-157

Summary of Key Issues

1. The issue is whether annual gifts of limited partnership interests made from 1996 - 2000 qualify for the Federal Gift Tax annual exclusion under Section 2503(b) of the IRS Tax Code of 1986.
2. The focus is solely on the distinction between a present interest gift (which is subject to the annual gift tax exclusion) and a future interest gift (which is not subject to the annual gift tax exclusion). There is no discussion of valuation discounts, such as a minority interest or marketability discount, which may have been applicable in this case.
3. The Court concluded that the limited partners who were recipients of the gifts received a substantial present economic benefit sufficient to render the gifts of limited partnership interests as present interest gifts, and accordingly qualify for the annual gift tax exclusion under Section 2503(b).
4. Notably, the issue of the present interest gifts depended on i) the partnership generating income; ii) some portion of that income flowing steadily to the donees; and iii) the donees portion of the income being readily ascertained.

Background. In 1996 and 1997, the Wimmers formed the George H. Wimmer Family Partnership, L.P. (the "Partnership"). The Partnership's primary purpose was to invest in property, including stock, bonds, notes securities and other personal property and real estate on a profitable basis and to share profits, losses, benefits, and risks with the partners. The partners intended the Partnership to increase family wealth, control the division of family assets, restrict nonfamily rights to acquire such family assets and, by using the annual gift tax exclusion, transfer property to younger generations without fractionalizing family assets.

The Partnership was funded with publicly traded and dividend-paying stock. The Partnership never held assets other than the publicly traded stock and the dividends received therefrom.

Gifts of limited partnership interest were made each year from 1996 to 2000. The estate bears the burden of proving that the gifts qualify for the annual exclusion.

The Partnership agreement generally restricts transfer of partnership interests and limits the instances in which a transferee may become a substitute limited partner. The transfer of limited partnership interests requires, among other things, the prior written consent of the general partners and 70% of the limited partners. Upon satisfaction of the transfer requirements, the transferee will not become a substitute limited partner unless the transferring limited partner has given the transferee that right and the transferee: 1) accepts and assumes all terms and provisions of the partnership agreement; 2) provides, in the case of an assignee who is a trustee, a complete copy of the applicable trust instrument authorizing the trustee to act as a partner in the partnership; 3) executes such other documents as the general partners may reasonably require; and 4) is accepted as a substitute limited partner by unanimous written consent of the general partners and the limited partners.

The Partnership received stock on a quarterly basis, and made distributions to limited partners in 1996, 1997, and 1998 for payment of Federal income tax. Beginning in February 1999 the Partnership continuously distributed all dividends, net of partnership expenses to the partners. Dividends were distributed when received and in proportion to partnership interests. In addition to dividend distributions, limited partners had access to capital account withdrawals and used such withdrawals for, among other things, paying down their residential mortgages.

The term "future interest" includes "reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time." (Sec. 25-2503-3(a), Gift Tax Regs.)

The term "present interest" is "An unrestricted right to immediate use, possession, or enjoyment of property or the income from property." (Sec. 25-2503-3(b), Gift Tax Regs.)

Commentary. The conflict between the "present interest" perspective which allows the annual gift tax exclusion and the "future interest" perspective which does not allow the annual gift tax exclusion has confounded estate planners since at least the Tax Court decision in the *Estate of Hackl* in 2002 (*Hackl v. Commissioner*, 118 T.C. No 14. Filed March 27, 2002). Similarly, in the case of *Price v. Commissioner* in January 2010, the transfer of certain limited partnership interests did not qualify for the annual gift tax exclusion. Most recently, in the case of *Fisher v. U.S.* in March 2010, the Court concluded that the transfer of membership interests in the Fisher's Limited Liability Company from the Fishers to the Fisher children were transfers of future interests and, therefore, not subject to the gift tax exclusion under Section 2503(b)(1).

Let's review these three cases in context with the Court's perspective on what constitutes a present interest in property, and how that is reflected in the case of *Wimmer v. Commissioner.*

Hackl v. Commissioner. We reviewed the *Hackl* decision in our newsletter *Value Added™* in 2002. Upon establishing a tree farm as an LLC, Hackl and his wife began to transfer ownership units to family members. On their tax returns, the Hackls treated these gifts as eligible for the annual exclusion. The IRS contested this classification, claiming that the transfers did not provide a present interest to the donees. To contain said interest, the gift must convey "substantial present economic benefit by reason of use, possession, or enjoyment of either the property itself or income from the property."

The Court ruled that the unusual restrictions in the operating agreement prevented the gifts from conferring a present interest. Specifically, the agreement granted the manager (A.J. Hackl) the authority to 1) appoint his own successor, 2) prevent withdrawal of capital contributions, 3) negotiate terms of resale of interests, and, most important, 4) prohibit any alienation or transfer of member interests. The Court focused not on the features of the interest gift, but on the underlying limitations of the interests being gifted. The Court employed a three-part test to determine whether the income qualified to be characterized as a present interest: receipt of income, steady flow to beneficiaries, and determination of the value of that flow. Because the LLC did not make distributions in the first years of operation, the Court ruled that the donees received no enjoyment of income from the property.

Our analytical perspective in 2002, which remains unchanged today, highlighted a concern regarding the definition of a present interest. The Court insists that, unless donees are receiving income distributions right now, their holdings contain no economic benefit today. Carried to its logical conclusion, this position says that only a portfolio of investment-grade fixed income securities has economic value at any given point in time. Further, in defining present interest, we believe that economic benefit entails more than immediate distributions. In the case of *Hackl*, the tree farm was highly likely to turn a profit in the long-term. Using the income approach, appraisers take the quantity of that future income and convert it to a present value. An income stream tomorrow counts for an economic benefit today. In short, present interest should also entail growth in value—the benefits from the appreciation of an underlying asset's worth during the holding period. Unless this concept is real, a portfolio of non-dividend growth stocks carries no value.

Price v. Commissioner. In *Price v. Commissioner* (T.C. Memo 2010-2), the Court found that the petitioners had failed to show that the gifts of partnership interests conferred on the donees an unrestricted and noncontingent right to immediately use, possess, or enjoy either the property itself or income from the property. Accordingly, the Court held that the petitioners were not entitled to exclusions under Section 2503 (b) for their gifts of partnership interests.

The Court focused on the following key elements of the facts and circumstances for this case:

- The partnership agreement expressly prohibits partners from selling, assigning, or transferring their partnership interests to third parties or from otherwise encumbering or disposing of their partnership interests without the written consent of all partners.
- Under the partnership agreement, the donees have no unilateral right to withdraw their capital accounts.
- Because of the operation of the partnership agreement, it appeared that the donees are not

properly characterized as limited partners in the partnership. The Agreement states: Any assignment made to anyone, not already a partner, shall be effective only to give the assignee the right to receive the share of profits to which his assignor would be otherwise entitled and shall not give the assignee the right to become a substituted limited partner.

- A right of first refusal in an option-to-purchase provision of the partnership agreement did not help, since it was subject to a complicated valuation process but without providing any time limit for exercising the purchase option with respect to a voluntary transfer.
- The petitioner alluded to the possibility that the donees could sell their partnership interests to the general partner. However, the Court countered by saying that if the possibility of a donor's agreeing to buy back a gift sufficed to establish a present interest in the donee, little would remain of the present interest requirement and its statutory purpose would be subverted if not entirely defeated.
- Finally, the record failed to establish that any ascertainable portion of the income would flow steadily to the donees.

Fisher v. U.S. In *Fisher v. U.S.* (105 A.F.T.R.2d 2010-1347 (S.D. Indiana) (March 11, 2010)), the Court ruled on a single issue: whether the gifts made by the Fishers to their children were transfers of present interests in property and, therefore, qualified for the gift tax exclusion under 26 U.S.C. Section 2503(b). The Fishers paid the gift tax deficiency claimed by the IRS and sought a refund of the deficiency.

The Fishers transferred 4.762% membership interests in Good Harbor Partners, LLC ("Good Harbor") to each of their seven children in 2000, 2001, and 2002. From the date of Good Harbor's formation through 2002, the company's principal asset was a parcel of undeveloped land that borders Lake Michigan.

The court considered three arguments made by the Fishers in support of their assertion that the transfers of interests in Good Harbor to the Fisher children were "present interests in property."

1. The Fishers argued that upon transfer the Fisher children possessed the unrestricted right to receive distributions of Good Harbor's Capital Proceeds. However, under the Operating Agreement, any potential distribution of Good Harbor's Capital Proceeds to the Fisher children was subject to a number of contingencies, all within the discretion of the General Manager.
2. The Fishers argued that upon transfer, the Fisher children possessed the unrestricted right to possess, use, and enjoy Good Harbor's primary asset, the Lake Michigan beach front property. However, there is no indication from Good Harbor's Operating Agreement that this right was transferred to the Fisher children when they became Members. It is a right to a non-pecuniary benefit.
3. Finally, the Fishers asserted that upon transfer, the Fisher children possessed the unrestricted right to unilaterally transfer their interests to Good Harbor. The Fishers argued that this right is a present interest in the property. However, according to the Operating Agreement, the Fisher children may unilaterally transfer their right to receive distributions from Good Harbor, but only if certain conditions of transfer are satisfied. These conditions include Good Harbor's right of first refusal, which effectively prevents the Fisher children from transferring their interests in exchange for immediate value, unless the transfer is to a family member – although even an attempted transfer to a family member is not without restrictions.

Based on the facts and arguments presented in the case, the Court concluded that the transfers of interests in Good Harbor from the Fishers to the Fisher children were transfers of future interests in property and, therefore, not subject to the gift tax exclusion under Section 2503(b).

Wimmer v. Commissioner. In this case, the Court continued its focus on the ownership and transfer restrictions included in the Operating Agreement. The Court interpreted the Operating Agreement to conclude that the donees' rights are limited with respect to the use, possession, or enjoyment of the property. For example, although limited partners may transfer their partnership interests to other partners and related parties, all other transfers are restricted unless certain requirements are met. Therefore, the Court concluded that the donees did not receive unrestricted and noncontingent rights to immediate use, possession, or enjoyment of the limited partnership interests themselves.

Having concluded that the limited partnership interests themselves were not present interests, the Court then considered a three-pronged test to determine if the limited partners' rights to income satisfy the criteria for a present interest under Section 2503(b). (Recall the regulations referenced above, which characterize a present interest as "An unrestricted right to immediate use, possession, or enjoyment of property or the income from property.") Accordingly, the *Estate of Wimmer* needed to prove, on the basis of the surrounding circumstances:

1. The Partnership would generate income;
2. Some portion of that income would flow steadily to the donees; and,
3. That portion of income could be readily ascertained.

With respect to the first prong, the Estate proved that on each date the Partnership made a gift of a limited partnership interest, the partnership expected to generate income. The principal assets consisted of publicly traded, dividend-paying stock.

With respect to the second prong, the fiduciary relationship between the general partners and the trustee of the grandchildren's trust showed that on the date of each gift, some portion of Partnership income was expected to flow steadily to the limited partners. Indeed, the limited partners not only received annual distributions but also had access to capital account withdrawals to pay down residential mortgages, among other reasons.

Finally, with respect to the third prong, the Court concluded that the portion of the income flowing to the limited partners could be readily ascertained. The Partnership held publicly traded, dividend-paying stock and was thus expected to earn dividend income for each year at issue. And, because the stock was publicly traded, the limited partners could estimate their allocation of quarterly dividends on the basis of the stock's dividend history and their percentage ownership interests in the Partnership.

Given the facts and circumstances of the case, the Court's focus on the income from the property was sufficient to conclude that the limited partners received a substantial present economic benefit. This rendered the gifts of limited partnership interests as present interest gifts on the date of each gift, and accordingly the gifts qualified for the annual gift tax exclusion under Section 2503(b).

Here's What's Important

- Restrictions on ownership and transferability typically included in Operating Agreements to achieve valuation discounts can preclude the transferred ownership interest from being characterized as a present interest gift – the characterization required to qualify for the Federal Gift Tax annual exclusion.
- The most recent focus on the rights to receive income clearly indicates, from the Court's perspective, that the entity must: i) generate income; ii) distribute some portion of that income steadily to the ownership interests; and iii) be able to readily ascertain the respective portions of that income.

Our conclusion articulated in 2002, is still appropriate in context with the Court's adjudication of the cases discussed herein:

> With regard to the restrictions in operating agreements, we maintain that analysts have constructed a false dichotomy between discounts and annual exclusion. It is possible to obtain both within the same gift. We would even cast doubt on the idea that unusually heavy restrictions guarantee any additional discounts beyond those contained in typical, "plain vanilla" agreements. The discounts for minority interest and lack of marketability derived from these latter type of agreements are substantial in size and indisputably eligible for annual exclusion. Furthermore, these discounts can be computed with high degrees of accuracy. How does one systematically determine the discount associated with a host of oddball provisions? And why would one, aware of the unfavorable tax consequences, endeavor such a calculation? LLC members gain nothing from restrictions that, in the process of deepening discounts, remove the present interest and disqualify the transfer for annual exclusion. While unusual restrictions may be necessary for the parties, they are not necessary for calculating discounts.

The Top 10 Things Estate Planners Should Know About Business Valuation

by James E. Graves, ASA, CFA

Estate planners work with business appraisers every day. Experience suggests that there are numerous aspects of business valuation that, when known to estate planners, greatly benefit the proposal and execution processes. We have compiled a "top 10" list of things every estate planner should know about business valuation. While a few of the items might seem obvious, to many they are not.

1. Define the Project

In order for the appraiser to plan the assignment, estimate the fee, and understand the client's specific needs, the estate planner needs to provide some basic benchmark information, such as: a description of the specific ownership interest to be appraised (number of shares, units, bonds); a clearly stated understanding of the "level of value" for the interest being appraised; a specific valuation date, which may just be current, or may be a specific historical date, and a description of the purpose of the appraisal (to inform the appraiser why your client needs an appraisal and how the report will be used).

2. Understand the Standard and Premise of Value

There are different standards of value for appraisals under certain circumstances and in different jurisdictions. Corporate and owner-level tax compliance appraisals are based on "fair market value," certain jurisdictions require "fair value" in dissenters' rights cases; and "liquidation value" may be appropriate in certain cases. Most appraisals are developed using a premise that the subject entity of the appraisal is a "going concern" in which business assets are used to conduct business versus being liquidated in a piecemeal sale of assets.

3. Involve the Appraiser Early On

Even in straightforward buy-sell agreements, family limited partnerships, or corporate reorganizations, it is usually helpful to seek the advice of the appraiser before the deal is finalized to see if there are key elements of the contract document that could be modified to provide a more meaningful appraisal to your client.

4. Distinguish Between a Business Appraisal and a Real Estate Appraisal

Many of the corporate entities appraised either own or rent the real estate where the business is operated. For a successful operating business, the most meaningful valuation is typically based on some measure of income, rather than the value of the underlying real estate. However, one should recognize that the value of some businesses, due to the nature of the subject business model, is better characterized by the value of underlying assets, and less so by the ongoing income. This is true for asset holding entities, and for some older family businesses with marginal earnings but with appreciated real estate on the books. Many business appraisers are not asset appraisers, and therefore, may need to consider a qualified real estate appraisal in the business valuation process.

5. Establish a Reasonable Time Frame

Each client's business appraisal is a custom piece of work. Clients rarely have available all the information requested at the outset of a business valuation assignment. Typically, a valuation project takes several weeks to complete once the engagement is authorization to proceed. Timing can be accelerated to meet special needs, but it is usually a good idea to avoid rushing the production of a complex appraisal project.

6. Insist on an Appraisal Firm with Experience and Credentials

Each business appraisal is unique, and experience counts. Most business valuation appraisers are generalists rather than industry specialists. However, many appraisers possess specific industry expertise. In many situations, valuation expertise combined with industry specialization is preferable. And, while appraisal credentials are no guarantee of performance, they do indicate a level of professionalism for having achieved and maintained them.

7. Know the Primary Business Valuation Methods

Business valuation is an art as well as a science, and appraisers utilize various valuation methods and treatments as required to appropriately address the unique considerations of each assignment. Key methods typically include: transactions method (focuses on actual transactions in the security being appraised); underlying net asset value method (considers estimates of fair market value of the entity's net assets, on a tax-adjusted basis); capitalization of earnings method (based on estimates of underlying earning power times a derived capitalization factor); guideline company method (similar to the capitalized earnings method, but uses comparable, or guideline companies to derive the appropriate capitalization factor) or discounted cash flow (derives the present value of future cash flows, based on a combination of projected future cash flow and a derived discount rate appropriate to the situation). Other valuation methods may be appropriate to certain companies in specific industries where particular comparable transaction data may be available.

8. Consider the Appraisal as a First Line of Defense

A well-reasoned and documented appraisal report serves as an indication of the seriousness and professionalism with which you address a client's needs. Having an independent valuation in a transaction situation provides a level playing field for negotiations in good faith on both sides. For tax-compliance cases, the appraisal serves notice to the other side that they need to be equally prepared to support a contrary opinion of value.

9. Litigation Support Issues

The business appraiser cannot serve as advocate for your client, but it is always helpful to have an experienced business appraiser available for expert opinion testimony. In addition to providing a well-reasoned and documented report, the appraiser must be able to articulate the reasonableness of valuation and investment conclusions to the court and be able to deal with intensive cross examination.

10. Expect the Best

In most cases, the fee for appraisal services is nominal compared to the dollars at risk and the marginal cost of getting the best is negligible. You can help your appraiser do the best job possible by ensuring full disclosure and expecting an independent opinion of value. The best appraisers have the experience and credentials described above, but recognize the delicate balance between art and science that enables them to interpret the qualitative responses to due-diligence interviews and put them in a stylized format that quantifies the results.

Mercer Capital has the experience and credentials to handle your client's appraisal assignment. For more information or to discuss a valuation issue in confidence, please contact any of our senior professionals at 901.685.2120.

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The Pros and Cons of Electing an S Corporation Status

by Nicholas J. Heinz, ASA and Wendy S. Ingalls, CPA/ABV, CBA, ASA

The S corporation status has been available to most corporations for many years. According to the Internal Revenue Service, S corporations are now the most common corporate entity.

It is increasingly rare to come across a company that qualifies to be an S corporation (and would benefit from being one) that has not gone ahead with the conversion process. That's not to say that all companies have taken advantage of this potential benefit.

If your business is structured as a C corporation it is well past time that you at least investigate the possibility of converting to S corporation status. A sub chapter S election for most companies can substantially enhance shareholder benefits, both on an interim basis and at the time of an eventual sale of the company.

Primary Advantages of Making the S Corporation Election

- **Single Layer of Taxation.** Shareholders escape double taxation of income as taxes are only paid at the shareholder level and not at the corporate level (a flow-through entity for tax purposes). While the income of the business continues to be taxable, shareholders incur no additional tax liability for receiving distributions.
- **Step-Up in Basis.** Shareholders in S corporations receive a step-up in the basis in their stock based on upon the amount of earnings retained each year. As with the avoidance of double taxation, a step-up in basis also reduces a shareholder's tax liability if the shares are ever sold because less of the proceeds are subject to capital gains tax.

These advantages can enhance after-tax proceeds to shareholders upon the sale of a business. Many transactions are structured as the sale of assets, rather than the sale of stock. Purchasing assets is generally more beneficial to the buyer and can generally lead to a maximization of the transaction price.

An asset sale of a C corporation will lead to a double layer of taxes (gains inside the company being taxed as well as taxes paid in getting the proceeds out to the shareholders).

An S corporation structure, with the single layer of taxation and the step-up in basis, typically provides more efficiency in terms of after-tax shareholder proceeds.

The Downside of Making the S Corporation Election

While the economics of an S election can be favorable, there are certain drawbacks, including:

- **Cash Flow vs. Tax Liability.** Regardless of whether a distribution is paid, shareholders will owe their pro rata share of taxes on the company's earnings. While this is a potential problem, proper understanding and planning of cash flow needs can easily eliminate any surprises in this area.

» **Built-in Gains.** If the entity or any of its assets are sold within ten years of S Corporation election, then the gain, based on the value at the conversion date, is taxable to the company. While this could be a downside relative to being an S Corporation without such built-in gain, there is no way to go back and convert at an earlier date.

If your business is structured as a C corporation it is well past time that you investigate the possibility of converting to S corporation status.

A sub chapter S election for most companies can substantially enhance shareholder benefits, both on an interim basis and at the time of an eventual sale of the company.

For a growing company, converting sooner rather than later will at least minimize the amount of gains captured for the ten year period.

» **Shareholder Limitations.** Initially, the Small Business Job Protection Act passed in 1996 specified that the company may have no more than 75 shareholders in order to qualify for an S election, and those shareholders must be qualifying shareholders (no IRAs or corporations).

The American Jobs Creation Act of 2004 ("AJCA") increased the number of eligible shareholders to 100. AJCA also allows that family members who are shareholders of an S corporation can elect to be treated as one shareholder.

Conclusion

While the above discussion outlines some of the primary advantages and disadvantages of an S election, any company considering such an election should discuss their specific considerations with their accountant or tax advisor.

If a company determines it should take advantage of its option to elect S Corporation status, a fair market value appraisal of the company is required as of the election date.

If you are considering converting to an S Corporation and, therefore, require a valuation, please contact us.

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Mercer Capital Highlights

Mercer Capital on the Road

September 10-12, 2012
AICPA Conference on Banks and Savings Institutions
Washington, DC
Andrew K. Gibbs, CFA, CPA/ABV
Jay D. Wilson, Jr., CFA

September 20-21, 2012
Notre Dame Tax & Estate Planning Institute
South Bend, IN
Nicholas J. Heinz, ASA
Brooks K. Hamner, CFA

October 2-4, 2012
ESOPs as a Succession Planning Tool
Memphis/Nashville/Birmingham
Nicholas J. Heinz, ASA

October 8, 2012
American Society of Appraisers Annual Business Valuation Conference
Phoenix, AZ

Non-Compete Agreements
Matthew R. Crow, CFA, ASA
The Banking Industry
Andrew K. Gibbs, CFA, CPA/ABV

October 15-19, 2012
Southern Federal Tax Institute
Atlanta, GA
Matthew R. Crow, CFA, ASA
Laura J. Stevens, CFA

October 25, 2012
Conference Keynote Presentation
National BVFA Conference of the Institute of Chartered Accountants in Australia
Melbourne, Australia
Z. Christopher Mercer, ASA, CFA, ABAR

Mercer Capital is Growing: Four New Analysts Hired

Mercer Capital is pleased to announce the additions of **Ms. Samantha L. Albert, Ms. Jessica L. Davis, Mr. Andrew J. Goldfein,** and **Mr. Treadwell B. Thompson** to our professional staff as Financial Analysts.

Ms. Albert is a graduate of The University of the South at Sewanee, holding Bachelor of Arts in Economics and Spanish. Ms. Davis holds a Bachelor of Arts in Economics and Business from Rhodes College. Mr. Goldfein is a graduate of Vanderbilt University, holding Bachelor of Arts in Economics and Spanish. Mr. Thompson holds a Bachelor of Arts in History from Vanderbilt University.

Mercer Capital Analysts Achieve 100% Pass Rate in the Chartered Financial Analyst Exam

Mercer Capital analysts have once again excelled in this year's Chartered Financial Analyst exam, achieving a 100% pass rate for the professional designation exams, which are sponsored by the CFA Institute.

Sujan Rajbhandary passed the Level 3 exam, **Alex M. Barry** passed the Level 2 exam, and **Whitney L. Faust**, **Mary Grace McQuiston**, and **Michael J. Sandler** passed the Level 1 exam.

The CFA charter is a globally recognized standard of expertise in investment analysis and portfolio management. Over 100,000 candidates around the world sat for the three levels of the charter tests this year. The overall pass rate for all candidates this year was just 44 percent.

A Reviewer's Handbook to Business Valuation

Practical Guidance to the Use and Abuse of a Business Appraisal

by L. Paul Hood, Jr., JD, LLM and Timothy R. Lee, ASA

Co-written by a business appraiser and tax lawyer, this book is written for users of business valuations and emphasizes the practical side of business valuation. There is something in this book for every person who is involved in the business appraisal process, including business owners, business appraisers, attorneys, CPAs who are not also business appraisers, and other users and reviewers of business

A Reviewer's Handbook to Business Valuation covers:

- » The basic valuation process, providing the reader with sufficient information to understand valuation theory without having to become a business appraiser.
- » Lessons from the trenches, including alleged errors of omission and commission by business appraisers that have ended up in court decisions.
- » A thorough discussion of the business valuation standards.
- » The authors' take on 10 burning issues in business valuation that drive attorneys and planners crazy.

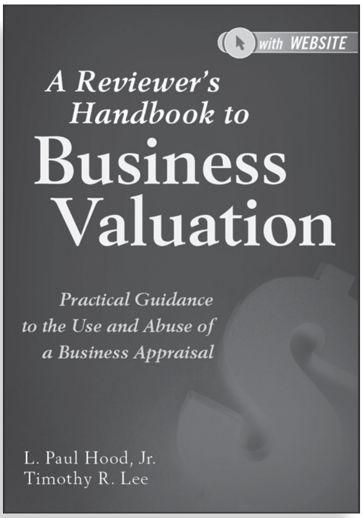
About the Authors

L. Paul Hood, Jr., JD, LLM

Paul is a frequent speaker, is widely quoted and his articles have appeared in a number of publications, including *BNA Tax Management Memorandum*, *CCH Journal of Practical Estate Planning*, *Estate Planning*, *Valuation Strategies*, and more. He has spoken at programs sponsored by a number of law schools, including Duke, Georgetown, NYU, Tulane, Loyola (N.O.) and LSU, as well as many other professional organizations, including AICPA and NACVA.

Timothy R. Lee, ASA

Timothy R. Lee holds the Accredited Senior Appraiser designation from the American Society of Appraisers and is a senior vice president and board member of Mercer Capital. Tim began his valuation career in 1994 and currently leads Mercer Capital's Corporate Valuation Service Group.



"*A Reviewer's Handbook to Business Valuation* is a powerful new resource instructing not only reviewers of business valuation as to how to identify issues—it is also a preparer's "must have" checklist for reviewing their own work."

Nancy J. Fannon
Fannon Valuation Group

"In one place you'll find the questions to ask, real-world guidance, the best, most understandable, primer on business valuation that you'll find anywhere, and a list of mistakes that others have made – so that you won't make them."

Stephan Leimberg
Leimberg Information Services

Learn More

For more information about **A Reviewer's Handbook to Business Valuation,** or to order your copy, visit the book's companion website at **www.bvreviewershandbook.com**

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