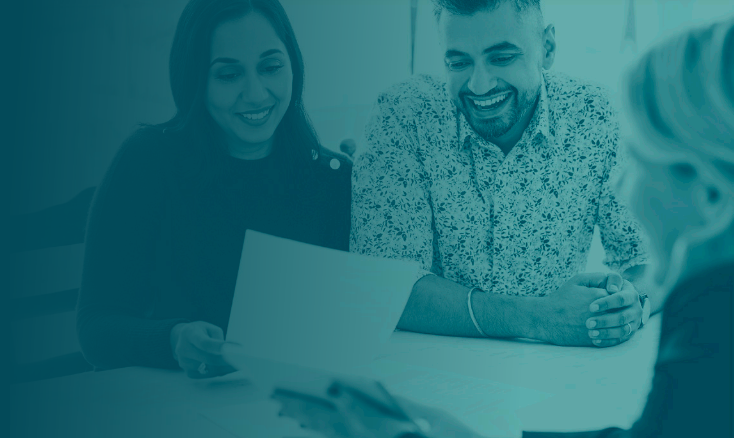
TRENDS 360

Valuations — *The Details Matter*



By: Jonathan M. Forster, Partner, and Hillary Hammond Cook, Associate, Baker & Hostetler, LLP

TRENDING

Valuations are a cornerstone of legacy and insurance planning. To stifle the use of so-called valuation discounts, in 2016, the IRS proposed regulations to limit valuation discounts for entities with no independent business purposes (i.e., family-controlled entities owning public stock investments). But then, in 2017, President Trump issued an executive order to identify excessively burdensome regulations, which eliminated the IRS' valuation-based proposed regulations. This set the IRS on a warpath against perceived valuation abuses. Several recent court cases and tax rulings evidence the intensity with which the IRS has been pursuing valuation challenges across several different fronts.

RELEVANCE

Valuation represents the intersection of liquidity needs and life insurance, as it directly impacts wealth-transfer planning.

Schlapfer v. Commissioner of Internal Revenue, Tax Court Memo. 2023-65
In Schlapfer v. Commissioner, the U.S. Tax Court addressed the issue of adequate disclosure on gift-tax returns. The taxpayer had filed a gift tax return in 2006, which included a sizable gift of stock from a Panamanian corporation. The IRS argued that the gift did not strictly comply with adequate disclosure rules, thus extending the statute of limitations for assessment. However, the court ruled that the taxpayer had substantially complied with audit and disclosure requirements, thus limiting the permissible assessment period to three years. This case underscores the importance of detailed and accurate disclosures in gift tax filings to avoid prolonged scrutiny of valuations by the IRS. It also shows the IRS' aggression in pursuing valuation disputes.

DeMatteo v. Commissioner of Internal Revenue, U.S. Tax Court (2022)
The DeMatteo v. Commissioner case involved the valuation of life insurance policies for gift-tax purposes. The taxpayer sought to use a particular method for valuing transferred policies, arguing that the IRS' preferred method was not mandatory. The IRS fought back, asserting the regulations required the taxpayer to use its specific interpolated terminal reserve (ITR) values. Ultimately, the parties agreed on stipulated values for the policies, leaving open the argument over which approach is proper for a future determination. This case highlights the IRS' recent commitment to pursuing valuation challenges in new ways.

IRS Chief Counsel Advice 202152018

In IRS CCA 202152018, the IRS took a stringent position on the valuation of private company shares transferred to a Grantor Retained Annuity Trust (GRAT). The donor used an outdated appraisal that did not account for a pending merger, leading to a significant undervaluation. The IRS Chief Counsel determined that the hypothetical willing buyer and seller would consider the pending merger in contemplation of a sale, thus affecting the valuation. Even though the GRAT included a mechanism to self-adjust its distributions to protect the transaction from gift-tax exposure, the IRS undermined this safeguard and blew up the GRAT, creating a heavy-handed gift tax for the taxpayer. This ruling emphasizes the need for contemporaneous and comprehensive appraisals. It also shows the IRS' ire in dealing with these issues.

IRS Chief Counsel Advice 202352018

In another Chief Counsel Advice memorandum, IRS CCA 202352018, the IRS addressed the gift-tax consequences of modifying a grantor trust to add a tax reimbursement clause (a clause commonly used). The IRS ruled that when beneficiaries consent to such a modification, they are making a taxable gift because the beneficiaries are relinquishing a portion of their interest in the trust by allowing the trustee to reimburse the grantor for income taxes paid on the trust's income. The ruling marks a significant shift from previous IRS positions and emphasizes the IRS' concentrated efforts to find taxable value in places it never had before.

Connelly Estate v. United States, U.S. Supreme Court (2024)

The Connelly Estate v. United States case revolved around the valuation of private company shares for estate-tax purposes following the death of a shareholder. The taxpayer argued that the value of the decedent's shares in the company should exclude the value of the life insurance proceeds from a policy owned by the company that the company would use to redeem the decedent's shares. The IRS argued that the corporation's redemption obligation did not offset the life insurance proceeds used to redeem such shares. Ultimately, the Supreme Court sided with the IRS and held that a corporation's contractual obligation to redeem shares is not necessarily a liability that reduces its value for estate tax purposes. This ruling could lead to a higher estate-tax burden for families who rely on life insurance-funded, redemption-based, buy-sell agreements to transfer ownership of their businesses.

CONCLUSION

Lesson: Valuations set the stage for the purchase and retention of life insurance. Legacy planning requires:

- Identification of a life insurance need.
- Magnitude of the problem (liquidity relative to transfer tax exposure).
- Implementation of the correct product and structure for owning the insurance.

HIGHLAND CAPITAL BROKERAGE | BakerHostetler