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THE IMPORTANCE OF QUALITY APPRAISALS

The Tax Court once again underscores how critical it is to have quality appraisals in valuation cases by its ruling in *Estate of Marjorie deGreef Litchfield v. Commissioner*. The estate was victorious in that the court agreed to grant over 85% of the discounts claimed on the 706 filed by the estate.

At the time of her death, Marjorie owned a 43.1% equity interest in Litchfield Realty Co. (LRC) and a 22.96% equity interest in Litchfield Securities Co. (LSC). Her interest consisted of what she owned directly plus her interest in a Sec. 2056 Q-TIP qualifying marital deduction trust established under her husband's will. He had predeceased her. Both entities had been established as Delaware corporations more than 80 years prior to Marjorie's death. LRC owned marketable securities and Iowa farmland which it rented to local farmers on a share-lease arrangement. LSC owned marketable securities only. The corporations were managed by their respective boards of directors and had substantially increased the value of assets held. LRC and its shareholders had executed a shareholder agreement shortly after the conversion to "S" status that prohibited the transfer of stock if it would jeopardize the "S" corporation status or the Iowa family farm corporation status. The agreement also gave LRC the right of first refusal to buy any LRC stock.

The estate utilized qualified appraisers and, supported by the appraisals created, claimed a combination valuation discount for:

(1) Potential capital gains tax liabilities

(2) Lack of control since it held only minority interests

(3) Lack of marketability since corporations were closely-held corporations

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The claimed discounts were 54.9% for LRC and 52.7% for LSC. The IRS audit took more than two years with the IRS finally issuing the 90-Day Letter, Statutory Notice of Deficiency, in which it claimed valuations over 50% more than that taken by the estate. The IRS claimed an estate tax deficiency of more than $6.2 million.

Many senior practitioners would remind us that it is in the best interest of an estate to shift the burden of proof to the IRS as permitted by IRC Sec. 7491(a) for any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed. The key is for the taxpayer to comply with substantiation requirements, adequate records, cooperate with reasonable IRS requests for witnesses, information, documents, meetings, interviews, plus meet the burden of credible evidence with respect to the factual issue or issues. In this case the Court concluded that the estate fully met the burden and the burden was shifted to the IRS.

The court then concluded:

(1) Built-in Capital Gains Tax Discount – The discount used by the estate was appropriate and fully took into account a reasonable discount to present value based on the holding periods and selling plans of the boards of directors.

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(2) Lack of Control Discount – The court reviewed in detail the appraisers' reports and testimony and again concluded that the estate's discount was proper.

(3) Lack of Marketability Discount – The court did not agree with either party on the proper valuation of this discount but reached a valuation that was approximately half way between those of the estate and the IRS. The court claimed that certain "outdated data" on restricted stock discounts had been used by the estate.

The case clearly shows the value and importance of a thorough and competent appraisal in support of discounts as well as making sure that current and relevant data support the discounts.

FAVORABLE TAX CONSEQUENCES FOR CHARITIES

In PLR 200847014 the Internal Revenue Service ruled that an individual who purchases a charitable gift annuity under a gift annuity agreement with a 501(c)(3) organization will be entitled to a charitable contribution deduction for income and gift tax purposes. The IRS further determined that the annuity would not be subject to the "charitable split dollar rules" added to the Code in 1999.

Now in PLR 200852037 we have an organization described in section 501(c)(3) and stating that it is a public charity asking for additional clarification. The charity operates facilities that serve as a home away from home for seriously ill children and their families and supports these programs by charitable gifts and contributions. To help increase funding, the charity has proposed using a charitable gift annuity program (CGA). The program will offer a charitable gift annuity to an individual (donor) and can be on the life of one or two individuals. The arrangement is payable from the charity's general assets. The donor and annuitant are aware that the charity will purchase an annuity from an insurer to match the charity's liability under the arrangement. The charity will purchase a single premium immediate annuity having the same payout period and periodic payment amount as called for by the arrangement. The amount received from the donor will exceed the cost of the commercial annuity and the charity will retain the difference for its immediate and unrestricted use. The charity will pay no compensation to the broker. For an additional consideration, the charity can receive an expanded annuity. If the annuitant dies before the total annuity payments, the charity would receive an amount equal to the original premium paid to the insurer less payments made under the annuity.

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The IRS issued the following rulings:

(1) The charity's charitable gift annuity will not constitute a "commercial-type insurance" policy under Section 501(m).

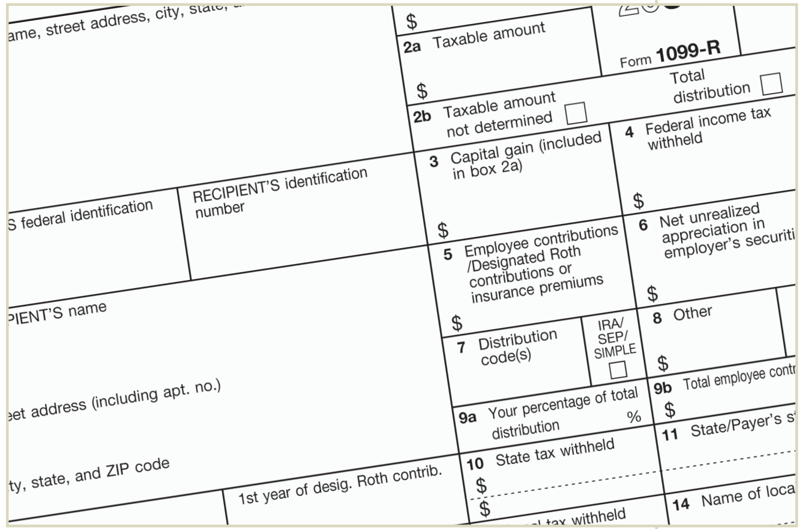
(2) The amounts received by the charity will not constitute income from an unrelated trade or business within the meaning of Section 513 of the Code.

The IRS clarified that the difference between the premium a charity will receive from a donor and the premium the charity will pay to an insurer for the commercial annuity is a gift. Gifts are not income and therefore cannot be unrelated business taxable income. The IRS further pointed out that Sec. 512(b)(1) of the Code excludes various items of income, including annuities, from unrelated business taxable income.

TERMINATION OF LIFE INSURANCE POLICY CAN TRIGGER INCOME TAX

In *Reinert v. Commissioner*, T.C. Summ. Op. 2008-163, a tax court determined that the taxpayer received gross income on the termination of a life insurance policy on his life. In addition, the court found that he was liable for an accuracy-related penalty for "substantial understatement" of income tax. The case helped clarify the meaning of the term "surrender" in section 72(e) of the IRC. What is interesting is that this clarification came about in a case involving very small sums, by a taxpayer not represented by counsel, and resulted in a clarification of an uncertain area of "surrender."

The taxpayer had purchased a life insurance policy with a face amount of $10,000 with a premium of $52.40 every 4 months until 2035. As the cash value increased, the taxpayer borrowed against it. In 2005, the cash value was $29,933.78 and the outstanding loan balance was $28,492.40. The total premiums paid at that time were $8,685.60.



Under the terms of the life insurance policy, if indebtedness equals or exceeds the cash value at any time, the policy terminates 31 days after a notice of termination has been mailed to the last known address of the policy owner. Taxpayer admits the receipt of the notice, that the policy was terminated, and that he received Form 1099-R showing a gross distribution of $29,933.78 and a taxable amount of $21,248.18. The difference was the premium paid by the taxpayer.

The taxpayer contends that the "termination" was not a taxable event because the pertinent statutes and regulations expressly apply only to a "surrender" of a policy.

The court found that upon termination there was no further contractual relationship, and that the taxpayer had been allowed to defer the increases in value of his policy for many years, a fact he overlooked. The taxpayer showed no authority, substantial or otherwise, for excluding the amount, and accordingly, the termination was a surrender of the policy. The taxpayer had $21,248.18 of income and the court upheld the 20% accuracy-related penalty for understatement of taxes.

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