

Countdown to the Closing of the Gift Tax Window - *A Valuation Perspective*

Webinar Presented by
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About Axiom Valuation Solutions

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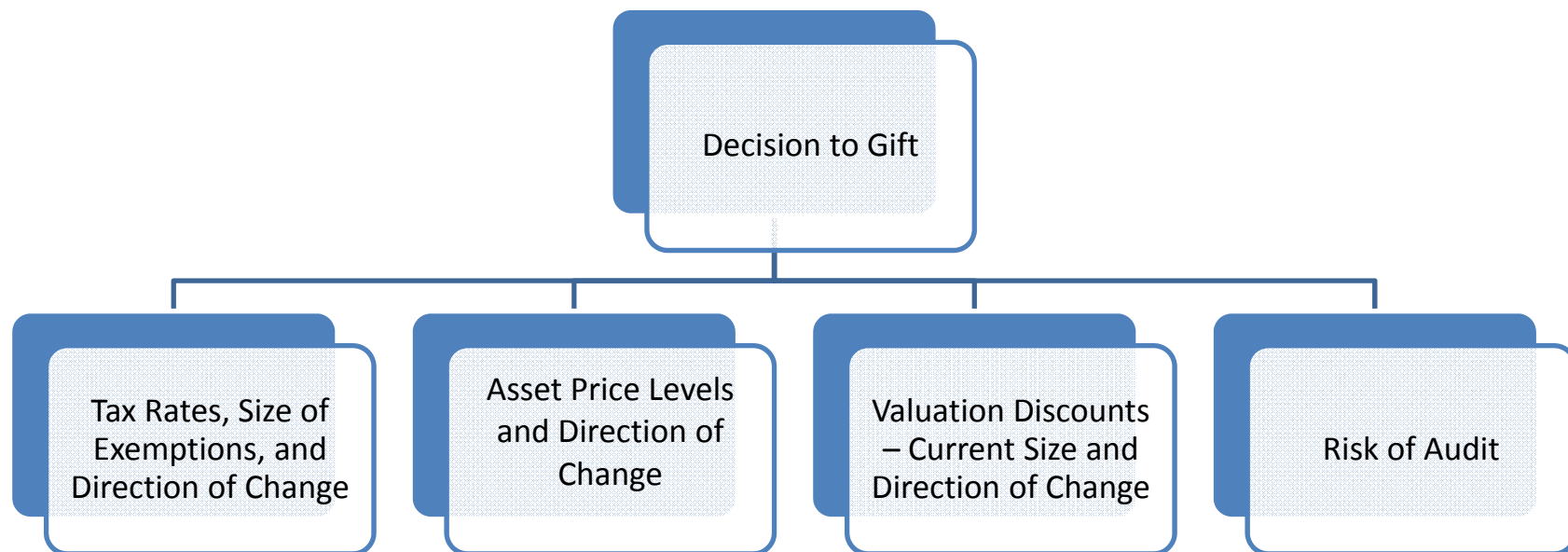
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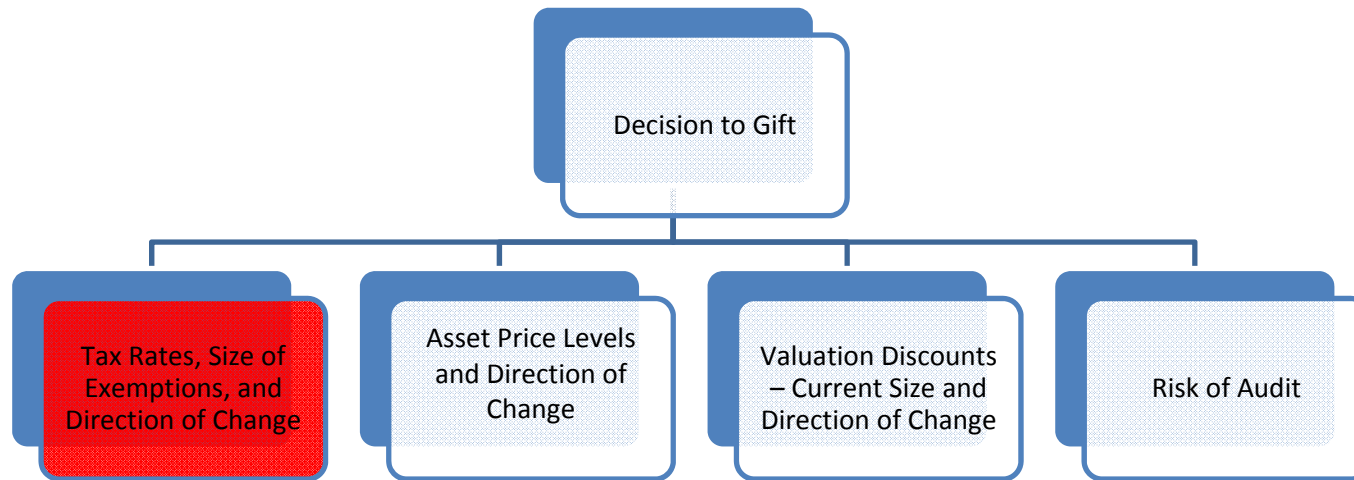
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Factors Influencing Decision to Gift

- Aside from the question of control of assets, decisions to gift should be made based on assessing the factors below in terms of current status and the likely direction of change.





Current Status and Possible Directions of Change

TAX RATES & EXEMPTION LEVELS

Key Changes between 2012 and 2013 if no action is taken

- The provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 are set to expire on 12/31/2012. Rates and exemptions revert back to 2001 levels.

Federal Taxes	2012	2013 and after
Top Gift Tax Rate	35%	55%
Gift Tax Exemption	\$5,120,000	\$1,000,000
Gift Tax Annual Exclusion	\$13,000	\$13,000 + inflation
Top Estate Tax Rate	35%	55%
Estate Tax Exemption	\$5,120,000	\$1,000,000
Portability of Unused Estate Tax Exemption between Spouses	Yes	No
GST Tax Rate	35%	55%
GST Tax Exemption	\$5,120,000	\$1,390,000 + inflation

What Else Needs to be Resolved between Now and Early 2013?

- Sequestration, i.e., the Fiscal Cliff
- Increasing the Debt Ceiling in January 2013
- Outcome of elections for President and Congress

Comparison of 2012 and President's 2013 Budget Proposal

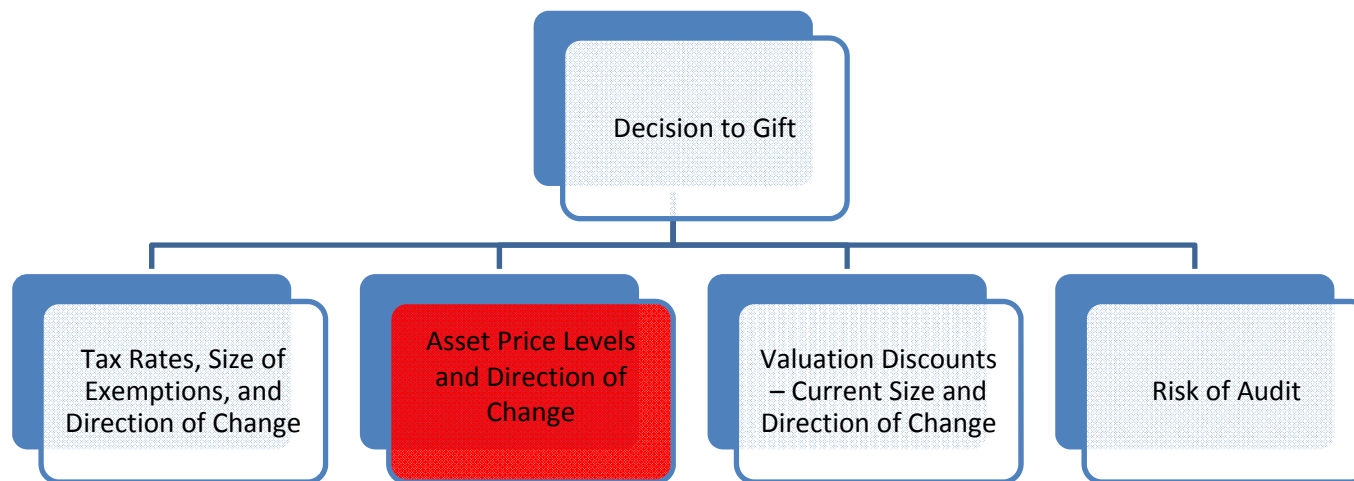
- One option already on the table for avoiding the return to 2001 levels is the President's FY 2013 budget proposal released early in 2012. The proposal also includes major changes to the use of valuation discounts.

Federal Taxes	2012	2013 Budget Proposal
Top Gift Tax Rate	35%	45%
Gift Tax Exemption	\$5,120,000	\$1,000,000
Gift Tax Annual Exclusion	\$13,000	\$13,000 + inflation
Top Estate Tax Rate	35%	45%
Estate Tax Exemption	\$5,120,000	\$3,500,000
Portability of Unused Estate Tax Exemption between Spouses	Yes	Yes, permanent change
GST Tax Rate	35%	45%
GST Tax Exemption	\$5,120,000	\$3,500,000 + inflation

Summary on Gift Tax Rates and Exemptions

- Gifting Opportunities Are Likely to be Greatly Restricted after January 2013 relative to 2012

Gift Tax Rates and Exemptions	Direction of Change
Tax Rates	Highly Likely to Go Up from 35%; Unlikely to Go Back to 55%
Exemption	Likely to Go Down Significantly from \$5.12 MM

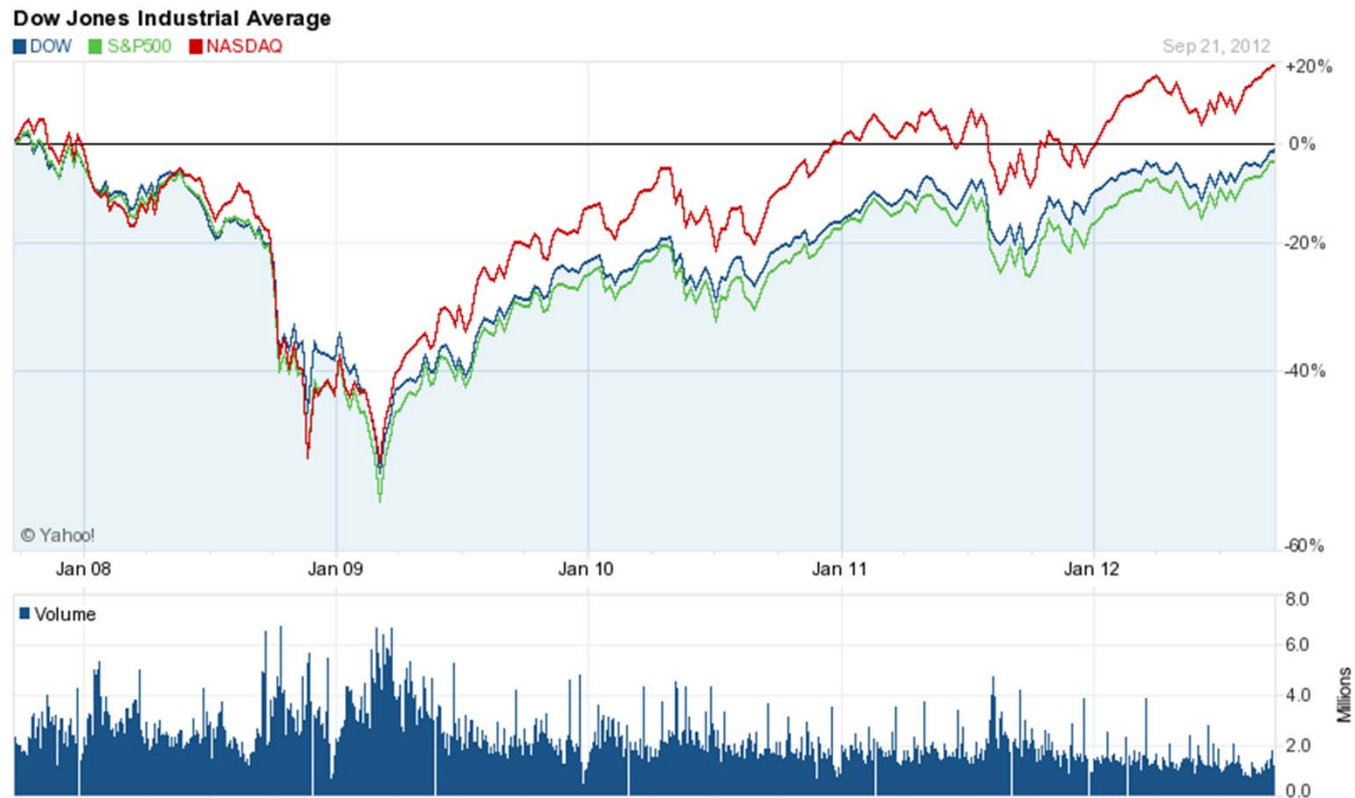


Current Status and Possible Directions of Change

ASSET PRICE LEVELS

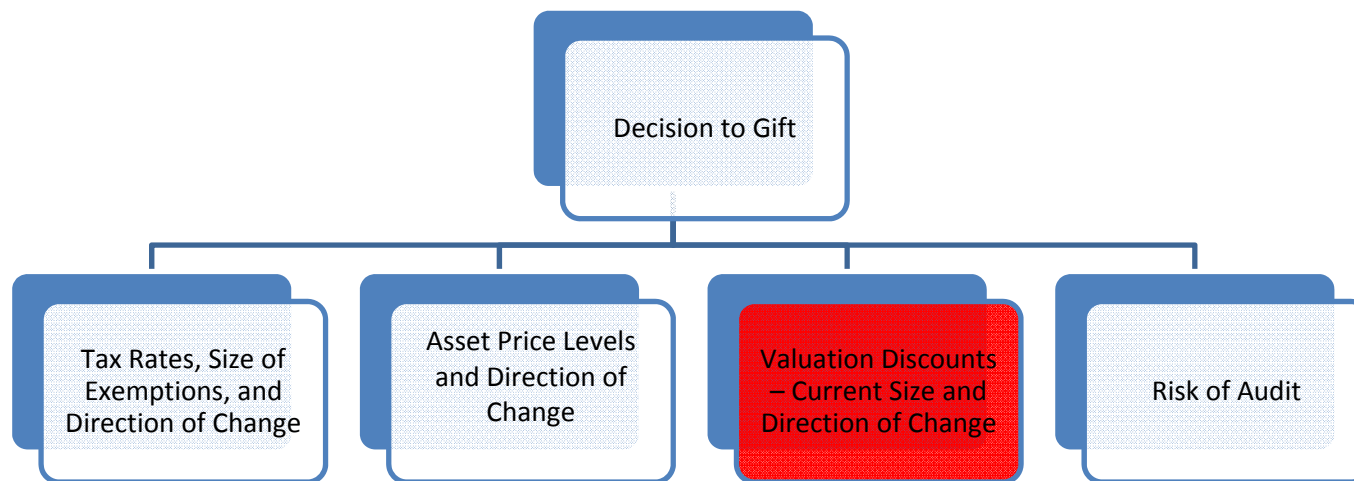
Stock Market Up Significantly Since 2009

- Asset values for many stock and bond investments are higher than in the recent past



Values of Most Other Asset Classes Have Increased Since 2009

- Asset values for the major asset types used for gifting are in many cases higher than in 2009
 - Stock in publicly held companies
 - Stock in privately held companies
 - Real estate
 - Family limited partnerships of all types
 - Farm Assets
- Direction of Change – Most likely to continue upward
- Summary – However, now is as good a time as any based on current values and direction of change



Current Status and Possible Directions of Change

VALUATION DISCOUNTS

Valuation Discount Demographics: Recent Evidence on Gifting Discounts

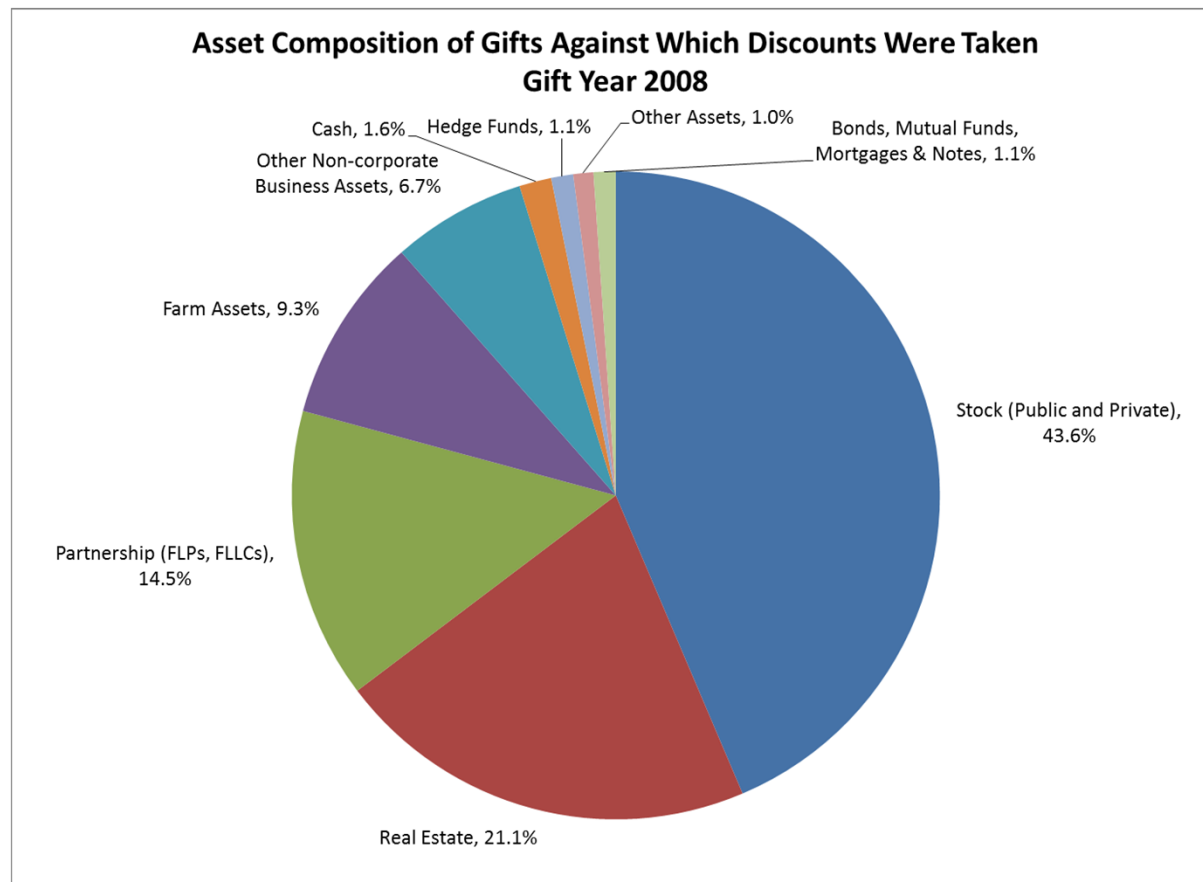
- In 2008, there were 234,714 gift tax returns filed. These included 102,608 gifts where discounts from the reported fair market value of the underlying assets were applied.
- 69% of the discounts taken were greater than 40%

Gifts Given with Discounts, by Size of Discount Percentage, Gift Year 2008		
<small>(All amounts are estimates based on samples - money amounts are in thousands of dollars)</small>		
Size of discount percentage	Number of discounted gifts	Amount of discount
All discounts	102,608	3,674,903
Less than 20 percent	7,291	106,825
Between 20 percent and 40 percent	24,655	472,404
Greater than 40 percent	70,663	3,095,674

Source: IRS Statistics of Income Bulletin, Spring 2011

Valuation Discount Demographics: Asset Composition of Gifting Discounts

- Stock and real estate make up almost 65% of the assets where discounts were taken



Source: IRS Statistics of Income Bulletin, Spring 2011

What Are Allowable Discounts from Fair Market Value of Assets?

- For direct gifts of assets, the discount opportunity is limited, except for privately held stock
 - A direct gift of publicly traded stocks or bonds has no discount opportunity
 - A direct gift of a fractional interest in real estate has a limited discount opportunity
 - A direct gift of privately held stock has significant discount opportunity
 - Lack of Control
 - Lack of Marketability/Liquidity
 - Special case – Built-in Gains for Assets in C Corporations

What Are Allowable Discounts from Fair Market Value of Assets?

- Sizable discounts to the fair market value of assets arise from placing assets into partnership, LLC, or other corporate entities and then gifting the securities of those entities
 - Discount to reflect lack of control of the entity and its assets
 - Discounts for lack of marketability or liquidity of the securities

Type of Entity	Control	Lack of Control
Partnership	General Partner	Limited Partner
LLC	Managing Member	Member
Corporation	Control Owner	Minority Owner

Federal Government Challenges to Valuation Discounts

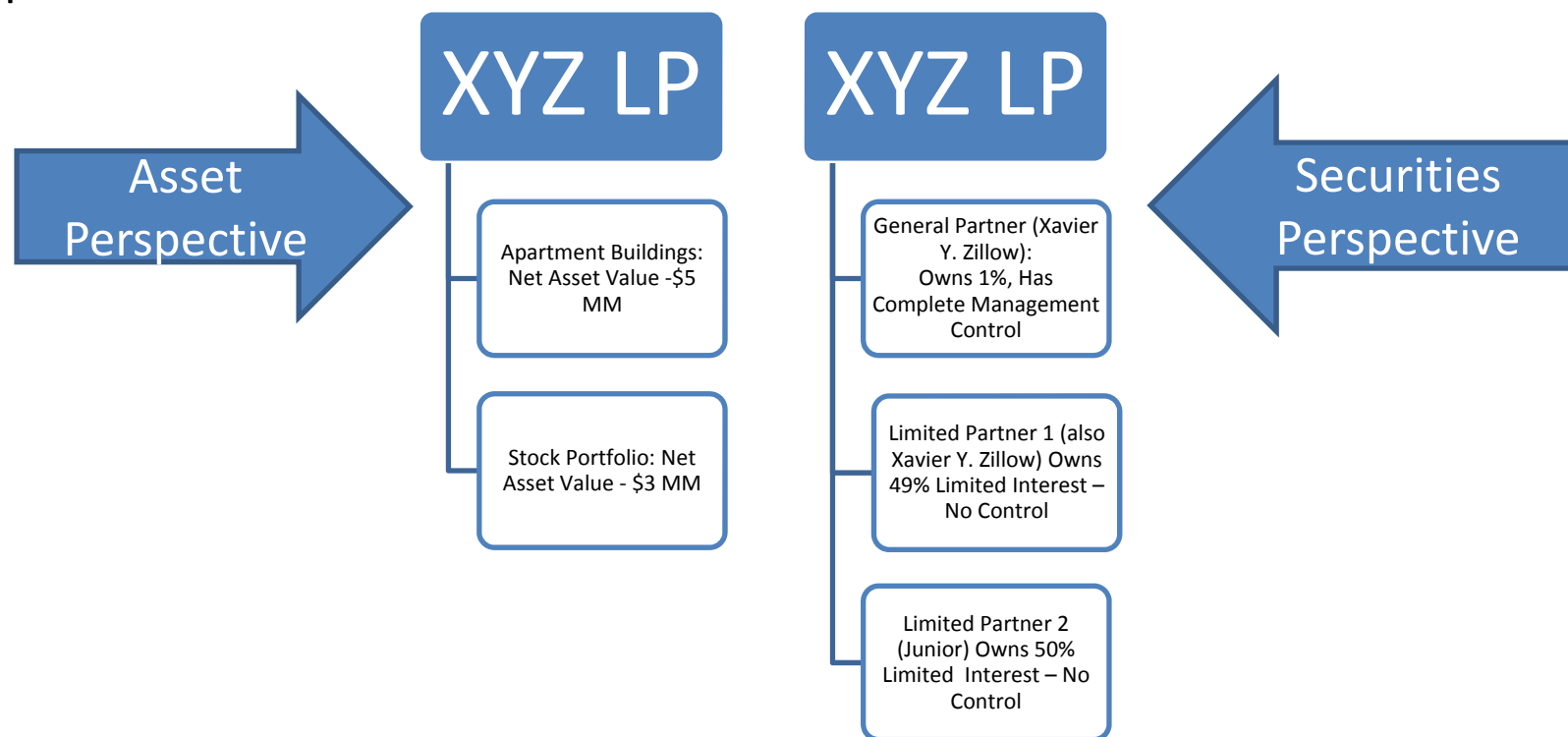
- First Line of Attack: IRS challenges whether the entity has a business purpose; if not, no discounts apply and possibly no transfers have taken place
- Second Line of Attack: President's proposals to reduce or eliminate "disregarded restrictions" that are used to support discounts for lack of marketability/liquidity
- Third Line of Attack: Other legislative proposals to eliminate or restrict use of minority discounts for family entities continue to be proposed

- Continued IRS push against FLPs and FLLCs
 - No business purpose
 - Not maintaining corporate records and form

- Proposals to Eliminate Use of Valuation Discounts for “Non-Actively Traded Businesses”
 - Proposed limiting of discounts for “disregarded restrictions” is targeted at discounts for lack of marketability – **Change is proposed to be retroactive to 1990**
- Continued IRS interest in eliminating discounts for lack of control as well
 - Will budget crisis provide the impetus for change?

Example of LP with Controlling and Non-Controlling Interests

- Limited Partnership with \$8 MM in net asset value
 - General Partner with a 1% interest and total control
 - Two Limited Partners (Xavier and Junior) – See interests below
- Xavier Y. Zillow wants to gift the remaining 49% non-controlling limited partner interest to Junior



What Size of Discounts for Lack of Control Can One Expect?

- Answer: It depends upon the type of asset and the valuation date
- Discounts for Lack of Control for Minority Stock, Limited Partnership, Non-Managing Membership Interest Must be Calculated Based on Empirical Data by Asset Type to Meet IRS Requirements

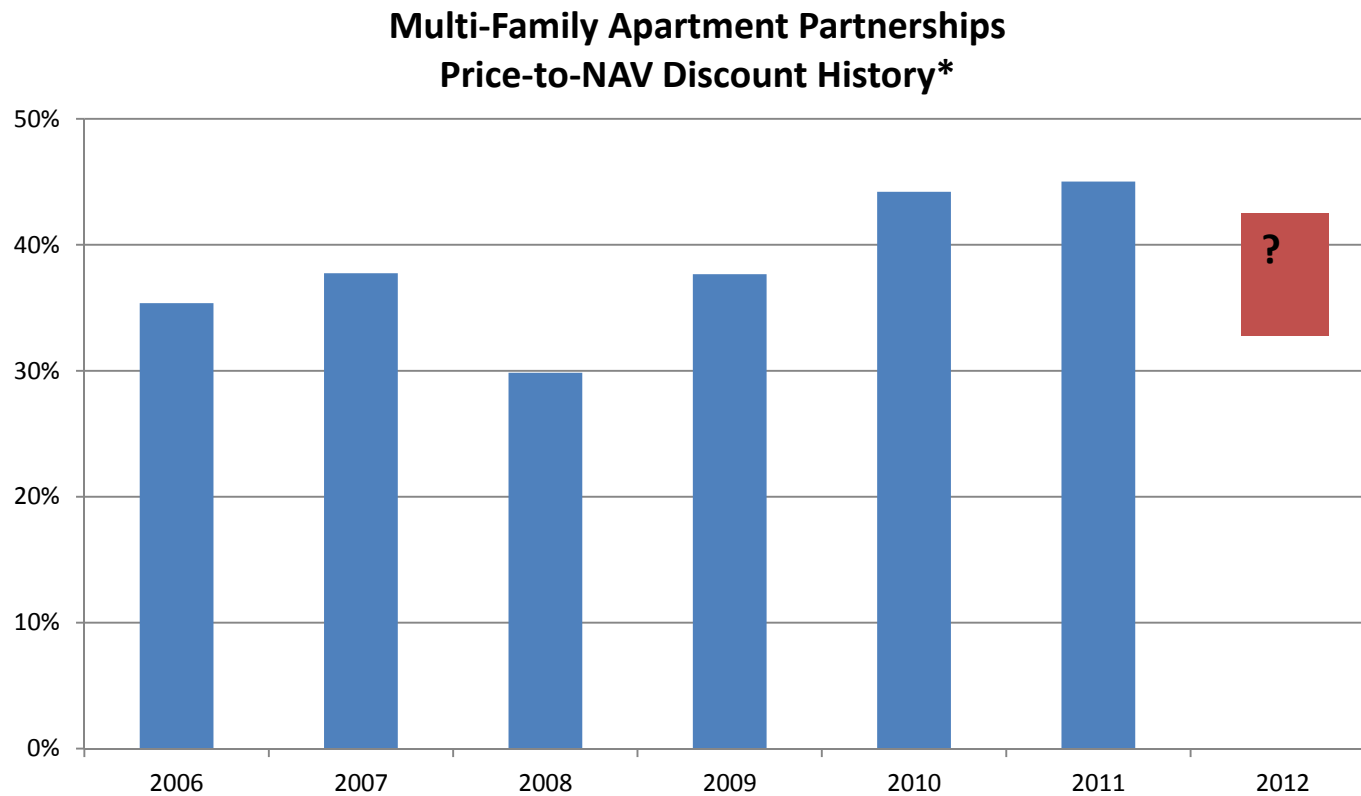
Asset Type	Source of Empirical Data
Real Estate (Commercial, Retail, Multi-Family, Land)	Partnership Profiles
Oil & Gas Interests	Partnership Profiles
Stocks, Bonds, Mutual Funds, Hedge Funds	Closed-end Funds with Similar Industry/Geographical Portfolio Composition
Privately-held Companies	Mergerstat Control Premium Study, Adjustments to Benchmark Compensation

Discounts for Lack of Control for Entities Holding Real Estate

- Partnership Profiles is source for real estate discounts
 - Over 340 publicly held limited partnership interests
 - Financial information reported as of December of the prior year, e.g. 2011, while the prices are reported for the April/May period of the current year.
 - Operating data is not released to the public by the partnership until the March/April timeframe.
 - **For 2012, the April/May values will not be available till December 2012.**
 - **Standard practice is to update using proxy closed-end funds from prior year, so currently the 2011 values updated to the valuation date are the best available source for discounts**

Lack of Control Discounts for Real Estate Asset Types

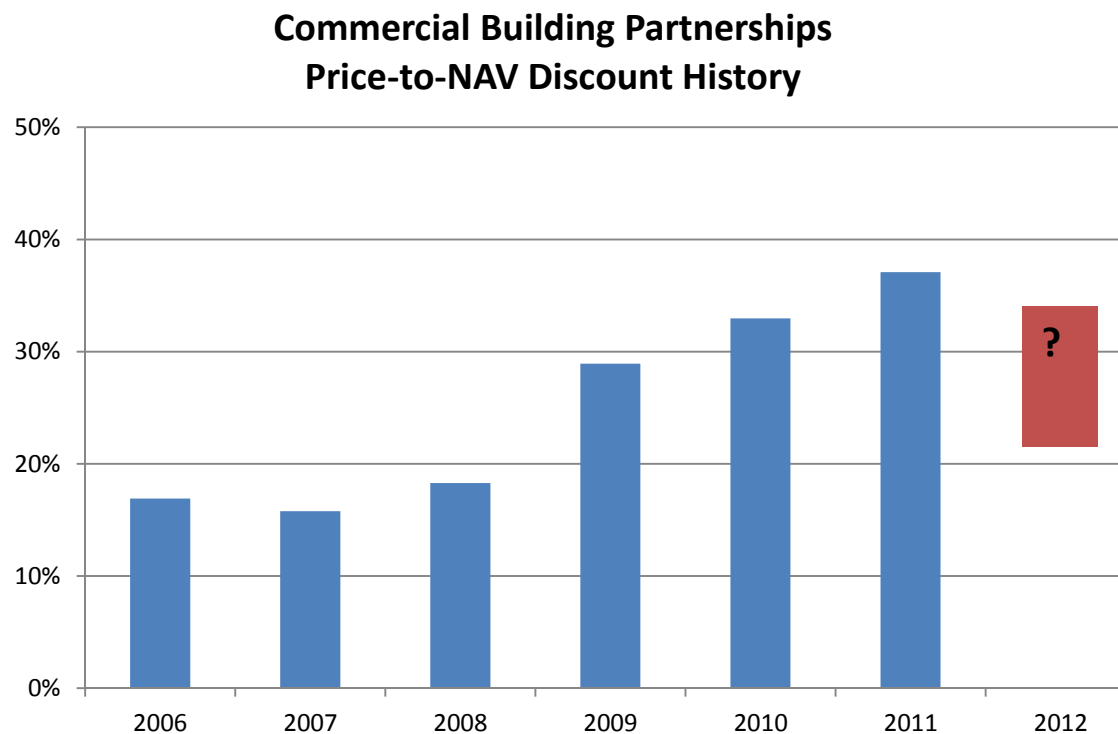
- Multi-Family Apartment Partnerships
 - Lack of Control Discount At Highest Level in 2011 Versus Recent History: 2012 Results Not Available till December 2012



*Only partnerships with single type of asset

Lack of Control Discounts for Real Estate Asset Types

- Commercial Building Partnerships
 - Lack of Control Discount At Highest Level in 2011 Versus Recent History: 2012 Results Not Available till December 2012

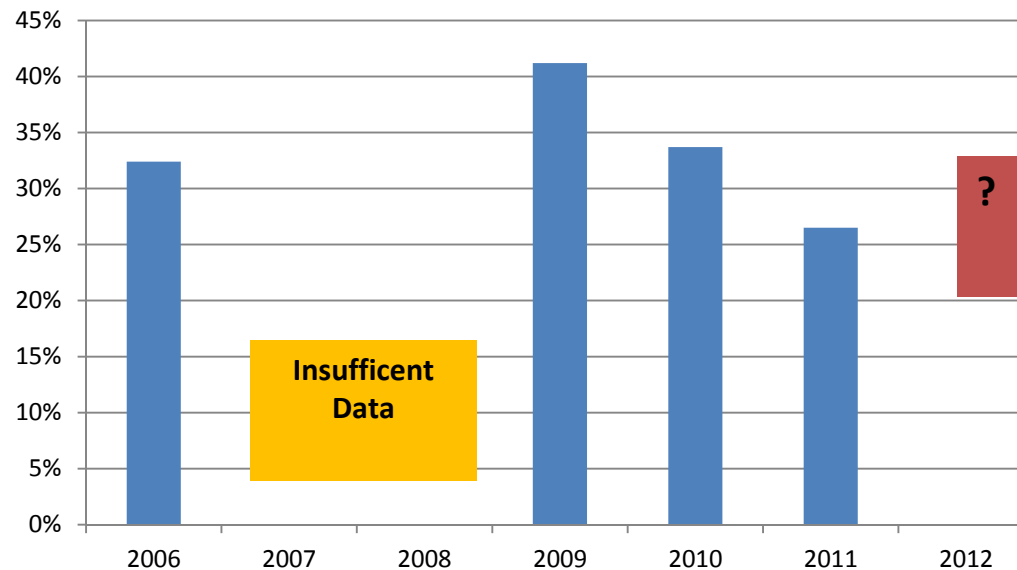


*Only partnerships with single type of asset

Lack of Control Discounts for Real Estate Asset Types

- Retail Buildings Partnerships
 - Lack of Control Discount Has Been Declining: 2012 Results Not Available till December 2012

**Retail Buildings Partnerships
Price-to-NAV Discount History**



*Only partnerships with single type of asset

Lack of Control Discounts for Real Estate Asset Types

- Land Partnerships
 - Lack of Control Discount At Highest Level in 2011 Versus Recent History: 2012 Results Not Available till December 2012



*All partnerships with land as one of the asset types

Discounts for Lack of Marketability/ Lack of Liquidity

- The Value of Interests in Private Entities are further discounted by a Lack of Liquidity and/or Marketability
 - The securities are not publicly traded, and thus are not covered by equity analysts
 - There are typically restrictions on the transfers of these assets, such as right of first refusal by other shareholders/partners/members, to limit the potential set of buyers
- Discounts for Lack of Marketability/Liquidity can reduce value from 10% to 25%

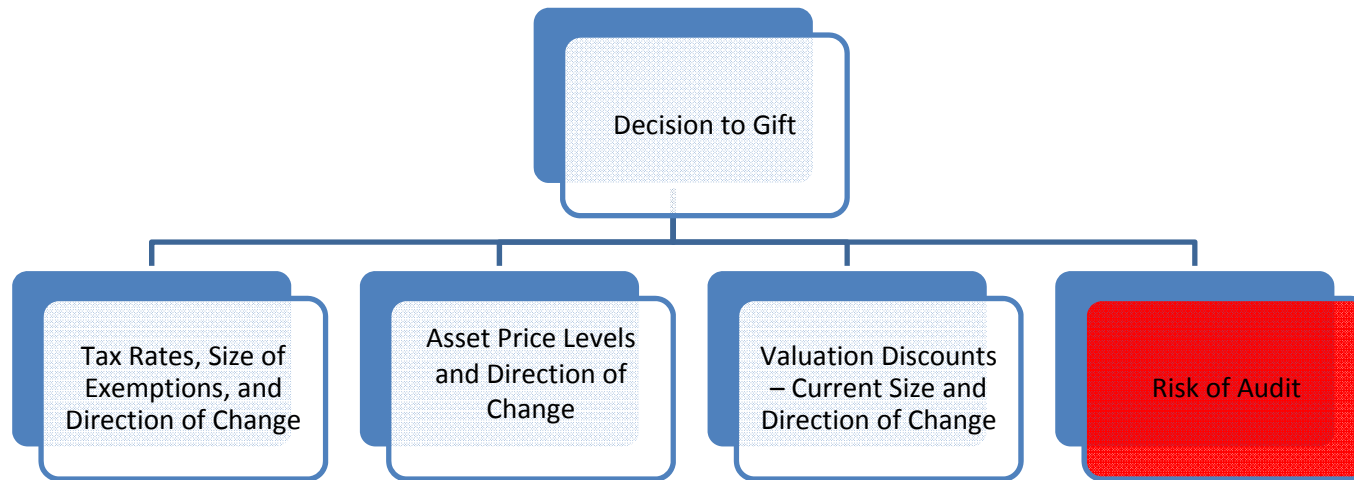
Example of XYZ LP: Impact of Putting Assets in LP Entity

- Limited Partnership with \$8 MM in net asset value
 - General Partner with a 1% interest and total control
 - Two Limited Partners (Xavier and Junior) – See interests below
- Xavier Y. Zillow wants to gift the remaining 49% non-controlling limited partner interest to Junior

XYZ LP	Asset Perspective
Apartment Building	\$ 5,000,000
Stock Portfolio	\$ 3,000,000
Net Asset Value	\$ 8,000,000
Value of 1%	\$ 80,000
Value of 49%	\$ 3,920,000

Value Reduction
of almost 50%

XYZ LP	Net Asset Value
Apartment Building	\$ 5,000,000
Discount for Lack of Control for Similar Real Estate Assets	44%
Value Adjusted for Lack of Control	\$ 2,800,000
Stock Portfolio	\$ 3,000,000
Discount for Lack of Control for Similar Closed End Equity Funds	12%
Value Adjusted for Lack of Control	\$ 2,640,000
Net Asset Value Adjusted for Lack of Control	\$ 5,440,000
Value of 1% Adjusted for Lack of Control	\$ 54,400
Discount for Lack of Marketability and Transfer Restrictions	25%
Value of 1% Adjusted for Lack of Control and Lack of Marketability	\$ 40,800
Value of 49% Adjusted for Lack of Control and Lack of Marketability	\$ 1,999,200



Current Status and Possible Directions of Change

RISK OF AUDIT

Despite Significant Drops in Asset Values, Recent Gifting Activity is Down

- Over 2006 to 2009, the number of gift tax returns filed has ranged from approximately 223,000 to 257,000, with 2009 the lowest
- Most returns result in no tax due to exclusions, deductions, and the unified credit
- Our guess is that 2012 will be the most active gifting year ever.

Gift Tax Returns	2009
Number of returns filed in 2010 for Gift Year 2009	223,093
Number of nontaxable returns	213,448
Number of taxable returns	9,645
Total gifts	\$37,872,051,381
Total annual exclusions	\$8,949,942,897
Total deductions	\$4,915,276,328
Taxable gifts, current period	\$24,015,252,407
Unified credit, applied	\$5,786,635,003
Total tax	\$2,453,681,984

What Has Been the Past Experience on Gift Tax Audits?

- Little information available on audit rates for gifts and estates
 - 0.6% of gift tax returns were audited in 2006, according to one source
- In contrast, 9.3% of estate tax returns were audited in 2008; 21.6% of those over \$5 million.
- Gift tax returns have generally been less likely to be audited, since the IRS can still come back and question them at the time of the estate tax filing.

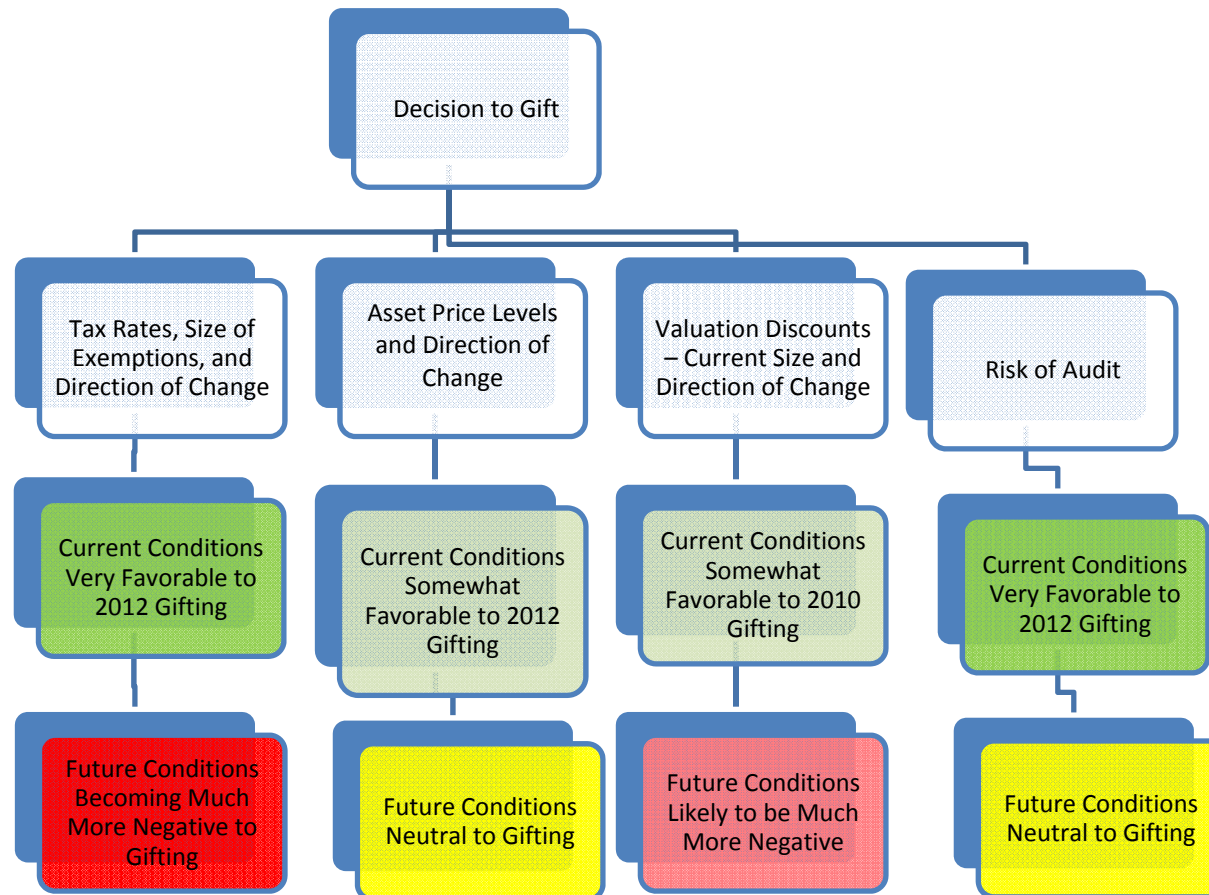
What is likelihood of audit for gifts filed in 2012?

- If there are record numbers of gift tax returns filed in 2012, this should reduce the likelihood of an audit. IRS resources have not been significantly increased.
- However, if the assets have not yet been placed in a discountable entity, there is a risk of not completing all the steps in the time necessary to make the entity effective.

- **What to Watch Out For**
 - Mistakes in documents, timing, dates of appraisals
 - Economic Substance challenges
 - Whether gift giver is competent to make gift
 - Failing to demonstrate that gifting entities, such as FLPs, operate independently and show documented activities
 - Discounts that cannot be supported by empirical financial data

Factors Influencing Decision to Gift

- Although current political conditions make it challenging to anticipate what will happen, the current conditions appear to be most favorable to gifting in the remaining months of 2012.



- IRS Review Process

- Estate & gift tax returns filed with Cincinnati Service Center
- First checked for completeness and computational accuracy
- Then reviewed by estate tax examiners by administrative territory
 - Estate tax examiners are attorneys
 - Generally have more experience than other examiners
- Most cases are resolved at the examiner level; there are incentives on both sides to settle early

- IRS Review Process (cont.)
 - Three formal levels of review
 - Estate tax examiner
 - Administrative review in the IRS appeals office
 - Litigation in U.S. tax court or other federal court
 - Primary situations where resolution at examiner level does not occur
 - Examiner decides to get expert help from IRS valuation engineer or independent valuation analyst
 - Absence of timely expert valuation analysis provided by taxpayer
 - Dispute on a point of law

- **Wandry v Commissioner [T.C. Memo. 2012-88]**
 - Taxpayers gave \$ denominated gifts of family LLC securities with the % transferred to be dependent upon the valuation
 - The couple gifted up to their exemption at that time, with the valuation to follow to determine % transfer of LLC interests
 - IRS challenged the use of a \$ denomination
 - Couple won on the point of being able to specify a \$ amount
 - IRS also contested that the eventual valuation of securities was too low
 - Court raised securities values by 20%

- **Built-in Gains for Assets in C Corporations**
 - Situations: Taxpayers gifting stock in C corporations where the underlying assets (i.e. real estate, stocks, et al.) have appreciated substantially in value above the tax basis.
 - If assets with a C corporation are sold, there is a Long-term Built-In Capital Gains of approximately 40% due on the gain.
 - Courts have increasingly been willing to allow the discounts to the stock value to reflect that recipients of the stock will have to pay that tax if they sell the assets in the future

- Time is tight, but the opportunity to move significant amounts out of client estates remains open and attractive for most.
- Careful planning and close coordination among advisors is essential to avoid problems that might invalidate the entity used for gifting interests

QUESTIONS