Best Practices Discussion

Service Alleges Taxable Gift for Exchange of Promissory Notes Based on Differences in Note Values

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This discussion provides an illustrative example of an unintentional gift that arose when one family generation exchanged assets with the next family generation. The assets were debt securities. The Internal Revenue Service (the "Service") alleged that the size of the gift was equal to the difference in the debt security face values—which was a substantial difference—on each side of the exchange. As it turned out, the difference in the debt security fair market values, which was the appropriate measurement of the amount of the gift, was significantly less than the amount of the gift alleged by the Service.

Introduction

One cause of an audit and notice of deficiency by the Internal Revenue Service (the "Service") is when the fair market value of a business interest or exchanged asset is disputed. Sometimes the Service is mistaken. And, sometimes the Service correctly identifies mistakes, flawed reasoning, or unsupported judgment related to the taxpayer's valuation. Sometimes the taxpayer neglects to have legal counsel retain a valuation analyst ("analyst") to appraise the asset that is gifted or exchanged.

This discussion presents an illustrative example of what was intended to be a reasonable swap of promissory notes between parents and their two children. Unfortunately, it proved costly to not have the taxpayer's counsel hire an analyst to value the transferred interest.

Lacking a qualified valuation report, the taxpayer incurred significant legal costs that could have been avoided—in addition to the costs of the analyst who could have been retained at the outset to avoid all of this. A stitch in time saves nine.

Fortunately, in this case, the taxpayer's counsel engaged Willamette Management Associates to provide valuation analyses and testifying expert services, resulting in a taxpayer-favorable settlement. All names, dates, types of companies, and amounts have been modified for illustrative purposes.

Background to the Alleged Gift

Breaking from Tradition, Parents Borrow from Children

A husband and wife (the "parents") owned and operated majority-owned, privately owned companies that operated in three sectors—hospitality, real estate, and restaurants. An opportunity arose to acquire a business that operated in one of these sectors, and the parents expected meaningful synergies with some of their current holdings.

The parents decided to swap several notes that they owned for the Parent Note, effectively extinguishing their indebtedness to the children. They exchanged these assets on February 18, 2010 (the "Exchange"). On one side of the Exchange, the parents received the note that they had owed.

On the other side of the Exchange, the Children's Holding Company received several notes, two of which were notes owed by each child to the parents.

An important factor affecting the fair market value of the notes was: not only were the notes received by the Children's Holding Company collateralized, but they were guaranteed per the allonge and guarantee of the assignor. The assignor was a trust of the parents.

The roadblock was the source of cash. The parents were nearly tapped out after pledging their personal assets against loans taken out by their business holdings. Their empire was overlevered. The parents could attempt to sell some of their existing holdings, but that would take time.

The parents' two children each had ownership interests in an investment holding company (the "Children's Holding Company") funded by the parents and structured as a limited partnership. Despite the children having nonvoting units, the parents spoke with the children about having the Children's Holding Company serve as the source of cash for the parents' acquisition. All parties agreed that the potential acquisition at the proposed terms was too good to pass up.

The parents obtained a loan from the Children's Holding Company in the form of a $50 million promissory note (the "Parent Note"). The loan proceeds were sufficient to acquire the business. The Parent Note was an interest-only note that paid interest at the prime rate. If the Parent Note went in default, it would pay the prime rate plus 3 percent.

I Will Forgive You . . . If You Will Forgive Me

After a little over six years, the parents decided they wanted to begin delevering their holdings, both at the personal and entity levels. In addition to the ownership of operating companies, real estate, and marketable securities, their assets included notes receivable from various entities and individuals.

If any of these notes went in default, the lender had the right to take title to the collateral. Because of the allonges and guarantees, if the collateral in liquidation did not cover all principal, any shortfall would be covered by the guarantee of the assignor. The assignor's net assets significantly exceeded the aggregate principal and accrued interest of the notes received by the Children's Holding Company.

Taxable Gift Alleged by the Service

The Service alleged that the size of the gift was equal to the difference between:

1. the outstanding principal and interest of the Parent Note and
2. the outstanding principal and interest of the five notes owned by the parents that were transferred to the Children's Holding Company.

This simple math does not add up, as such a face value comparison is inconsistent with the concept of fair market value.

Exhibit 1 displays the outstanding principal and accrued interest of each note. The Children's Holding Company, in exchange for transferring the Parent Note to the parents, received five notes owed to the parents by (1) Recreation Holdings, LLC; (2) Insurance Policy Holdings, LLC; (3) a business associate of the parents; and (4) the two children (the "Children Notes").

Exhibit 1
Assets Exchanged between Parents and Children's Holding Company
Alleged Size of Gift Subject to Taxation
As of February 18, 2010

Promissory Notes Given to Parents by Children's Holding Company:	Outstanding Principal $	Outstanding Accrued Interest $	Outstanding Principal and Interest $
Childrens' Holding Company Was the Lender			
Debtors:			
Parents	50,000,000	10,000,000	60,000,000

Promissory Notes Given to Children's Holding Company by Parents:	Outstanding Principal $	Outstanding Accrued Interest $	Outstanding Principal and Interest $
Parents Were the Lenders			
Debtors:			
Recreation Holdings, LLC	30,000,000	2,800,000	32,800,000
Insurance Policy Holdings, LLC	5,000,000	200,000	5,200,000
Business Associate of Parents	5,000,000	1,000,000	6,000,000
Son	1,500,000	-	1,500,000
Daughter	1,500,000	-	1,500,000
			47,000,000
Taxable Gift by the Children to the Parents as Alleged by the Service			**13,000,000**

Recreation Holdings, LLC, owned and operated a large marina and resort. A significant portion of its assets was its 99-year leasehold with the Department of the Interior. Insurance Policy Holdings, LLC, was a holding company that owned life insurance policies on the lives of the parents.

The purpose of the loan was to pay for the issuance policy premiums, and the holding company also held cash. The note owed by the business associate was collateralized by real estate properties, and the purpose of the loan was to acquire residential apartment communities.

Including accrued interest, the Parent Note had a nominal value of $60 million. This amount exceeded, by $17 million, the aggregate nominal value of the Children Notes. This amount was the amount the Service alleged was a taxable gift to the parents by the Children's Holding Company.

Exhibit 1 presents the obligor of each note and its outstanding principal and interest.

The Matter Is Litigated—Tax Counsel Retains a Valuation Analyst

The Value Gap Is the Gift—Fair Market Value Is the Standard

The Service claimed that the gift was the amount of the "value gap" based on outstanding principal and accrued interest. However, the exchanged note value gap may be higher or lower than the face value value gap at *fair market value*.

In this illustrative example, counsel was hired to litigate the notice of deficiency, and tax counsel then retained an analyst to provide an opinion of the fair market value of each note exchanged.

Fair market value, as this term is used in the Internal Revenue Code and set forth in the Treasury Regulations, is defined as the price at which the subject interest would change hands between a hypothetical willing buyer and hypothetical willing

seller, with both having reasonable knowledge of all relevant facts, and neither party being under any compulsion to buy or sell. Fair market value also assumes that the price is paid all in cash or its economic equivalent at closing.

First Steps in the Valuation Analysis

When counsel retains an analyst, one part of the process is identifying and requesting all pertinent documentation. If the taxpayers orally represented that some percentage of their assets were pledged on loans, it is preferred to obtain written documentation rather than an oral representation.

If the assets involved in the dispute include notes, the analyst may need certain data, such as the indenture, history of the timeliness of payments and accrued interest, and an analysis of the value of any collateral (if there are security interests attached).

If the note is collateralized, it may be important to identify the assets that serve as collateral and identify which data are required to estimate the value of the collateral.

Valuation Analysis

The remainder of this discussion analyzes each of the notes exchanged, the fair market value of each, the total fair market values on each side of the Exchange, and the taxable gift.

The Exchange occurred on February 18, 2010, not long after the crashes of the capital markets and real estate sector. One of the fulcrums for the fair market value of a private company note is the selected market-based yield.

Initial Observations

Parent Note—Considerations

The Parent Note was unsecured and in serious default, both on the principal and the accrued interest. A hypothetical buyer of the note would consider this a risk despite the size of the parents' business holdings.

From the risk perspective of a lender, it is not just a matter of whether you have the money to pay me back, it is a matter of whether you will, in fact, pay me back the money.

An analysis of the corporate holdings of the parents, the scope of their guarantees of loans to their corporate holdings, and the parents' annual cash flow indicated that a reasonable Moody's rating for the Parent Note was CCC for corporate bonds.

Years prior to 2009, the parents would have obtained a much higher credit rating. However, the parents credit rating suffered after the crash of the real estate sector.

Children Notes—Considerations

The Children Notes were all secured. Additionally, all the notes had an allonge and guarantee of a trust of the parents. A review of the indentures reveals that all but one of the five notes had durations of less than a year. For instance, one note was a demand note and another note was in default and was secured by real estate.

The following section discusses each of the notes, the analysis of risk factors and terms, and illustrative examples of the fair market values of each note. This example shows that the amount of the alleged gift is far less than the amount that was alleged by the Service.

Fair Market Value of the Parent Note

Although the obligors of the Parent Note are individuals, not corporations, the parents' primary assets are the companies that they control and operate. As individuals, the parents are exposed to similar risk/reward factors as the companies they own.

In this example, the market-based yield to apply to the Parent Note is selected based on indicated yields on corporate bonds with similar durations.

As presented in Exhibit 2, the parents' sector exposure was to hospitality, real estate, and restaurants at 50 percent, 25 percent, and 25 percent, respectively. To reasonably incorporate the lending risk of each sector, this example applies a weighted average market yield based on the indicated market yield of each sector.

The analysis considers individual debt securities as guideline securities to arrive at an indicated market yield to apply to the Parent Note.

Exhibit 3 presents the credit ratings, years to maturity, and yield to maturity of selected guideline bonds. Each guideline bond was unsecured (as was the Parent Note) and had varying durations. Exhibit 3 provides an illustrative example of how an analyst would arrive at an indicated market yield of 17.73 percent for the hospitality sector.

Debt securities with Moody's rating CCC were selected for the following reasons:

1. The Parent Note was in default.
2. No principal had been paid well past maturity.

Exhibit 2
Sector-Based High Yield Data
Weighted Average Yield
Based on Parents' Industry Sector Exposure

Industry Sector	Parents' Assets by Sector $	Weight %	Indicated Market Yield %	Weighted Yield %
Hospitality	200,000,000	50.00%	17.73%	8.87%
Real Estate	100,000,000	25.00%	17.24%	4.31%
Restaurants	100,000,000	25.00%	16.50%	4.13%
Total	400,000,000	100.00%		17.30%

Weighted Average Market Yield	**17.30%**

3. Many of the parents' assets had been pledged, leaving few assets to sell so in order to make principal payments on the Parent Note.

There was no new maturity date by contract. In this illustrative example, the selected maturity date is predicated on a loan workout or an extension of the maturity date by the lender. Many of the parents' assets had been pledged to guarantee other loans.

Estimating when the parents may be able to begin paying principal required an analysis of the parents' current assets, their expected future cash flow, and all obligations, guarantees, and seniority in the pecking order among lenders. These factors, in this example, resulted in selecting eight years as a maturity date.

An adjustment was applied to the indicated yields because none of the comparable bonds had exactly an eight-year duration. In fact, many were well below eight years. Matching durations is important in selecting a reasonable, market-based yield.

To adjust the indicated yields to what they would be if the bonds had an eight-year duration, this example applies an exponential yield from the publicly traded debt.

Regression analysis results in the following formula for the slope and intercept: $Y = 0.0877 \times (EXP(0.88 \times 8)$, where the "times 8" refers to the duration of the subject note. This results in a duration-adjusted, market-based yield of 17.73 percent, whereas the median was 12.00 percent. The median, which would be improper to use with such wide differences in durations from the subject note, is much less because many of the publicly traded bonds have durations of only one to three years. In contrast, the Parent Note matures in eight years.

The longer the maturity, the higher the risk. Therefore, the higher the yield demanded by the market to compensate for taking on more risk.

Exhibit 4 applies the weighted average market yield of 17.30 percent, based on the parents'

Exhibit 3
Market Yields—Hospitality Industry
As of the Date of Transfer

Publicly Traded High Yield Debt Issued by Hospitality Industry Companies	Seniority	Credit Rating	Years to Maturity	Yield to Maturity
Company A	Unsecured	CCC	3.70	12.00%
Company B	Unsecured	CCC	3.70	12.00%
Company C	Unsecured	CCC	7.90	15.00%
Company D	Unsecured	CCC	7.49	16.00%
Company E	Unsecured	CCC	2.57	14.00%
Company F	Unsecured	CCC	0.61	12.00%
Company G	Unsecured	CCC	9.53	22.00%
Company H	Unsecured	CCC	7.74	18.00%
Company I	Unsecured	CCC	7.12	19.00%
Company J	Unsecured	CCC	3.45	12.00%
Company K	Unsecured	CCC	2.95	10.00%
Company L	Unsecured	CCC	2.95	12.00%
Company M	Unsecured	CCC	2.55	8.00%
Company N	Unsecured	CCC	0.84	8.00%
Company O	Unsecured	CCC	1.25	10.00%
Exponential Public Debt Yield (adjusted for 8 years to maturity for subjec				17.73%
Selected 8-Year Public Debt Yield				**17.73%**

Exhibit 4
Promissory Note Owed by the Parents to the Children's Holding Company
Fair Market Value
As of February 18, 2010

Based on Selected High Yield Indexes of Transportation, Banks, and Real Estate:

Outstanding Principal ($)	50,000,000	(equals original principal)
Outstanding Accrued Interest ($)	10,000,000	(debtor has paid no interest and is in default)
Maker/Debtor	Parents	
Note Holder	Childrens' Holding Company	
Valuation Date	2/18/2010	
Issuance Date	6/30/2003	
Interest Rate	6.25%	(prime plus 3% when in default)
Type	Interest Only	
Payment	Annually	
Maturity Date	12/31/2017	
Selected Risk-Adjusted Rate	**17.30%**	

Payment Date	Beginning Principal and Accrued Interest $	Annual Interest $	Partial Period	Adjusted Annual Interest $	Payments of Original Accrued Interest	Total Payments $	Ending Principal and Accrued Interest $	Total Payment ($)	Discounting Period	Present Value Factor 17.30%	Present Value of Total Payment $
12/31/2010	60,000,000	3,750,000	0.87	3,246,575	1,250,000	4,496,575	58,750,000	4,496,575	0.8658	0.8710	3,916,517
12/31/2011	58,750,000	3,671,875	1.00	3,671,875	1,250,000	4,921,875	57,500,000	4,921,875	1.8658	0.7425	3,654,492
12/30/2012	57,500,000	3,593,750	1.00	3,593,750	1,250,000	4,843,750	56,250,000	4,843,750	2.8658	0.6330	3,066,094
12/31/2013	56,250,000	3,515,625	1.00	3,515,625	1,250,000	4,765,625	55,000,000	4,765,625	3.8658	0.5396	2,571,531
12/31/2014	55,000,000	3,437,500	1.00	3,437,500	1,250,000	4,687,500	53,750,000	4,687,500	4.8658	0.4600	2,156,250
12/31/2015	53,750,000	3,359,375	1.00	3,359,375	1,250,000	4,609,375	52,500,000	4,609,375	5.8658	0.3922	1,807,797
12/30/2016	52,500,000	3,281,250	1.00	3,281,250	1,250,000	4,531,250	51,250,000	4,531,250	6.8658	0.3343	1,514,797
12/31/2017	51,250,000	3,203,125	1.00	3,203,125	1,250,000	54,453,125	-	54,453,125	7.8658	0.2850	15,519,141
				27,309,075	10,000,000	87,309,075		87,309,075			34,206,619
							Indicated Fair Market Value ($) (rounded)				**34,207,000**

exposure to three sectors, to arrive at the present value of future cash flow from the Parent Note.

As presented in Exhibit 4, the parents received this loan from the Children's Holding Company about six and a half years before the Exchange. They owed $50 million in principal. Having been in default on interest payments, they owed $10 million in accrued interest.

The note was unsecured and, being subordinate to all other lenders to the parents and the entities they controlled, relied on the future cash flow of the parents to meet its obligations.

Selecting a maturity date, such as a new one negotiated between a hypothetical willing buyer and hypothetical willing seller, may be based on an analysis of the parents' cash flow and the financial conditions of the parents controlled holdings.

Two factors that may be taken into account are (1) the stability of cash flow of companies controlled by the parents and (2) the predictability of future distributions from the companies to the parents.

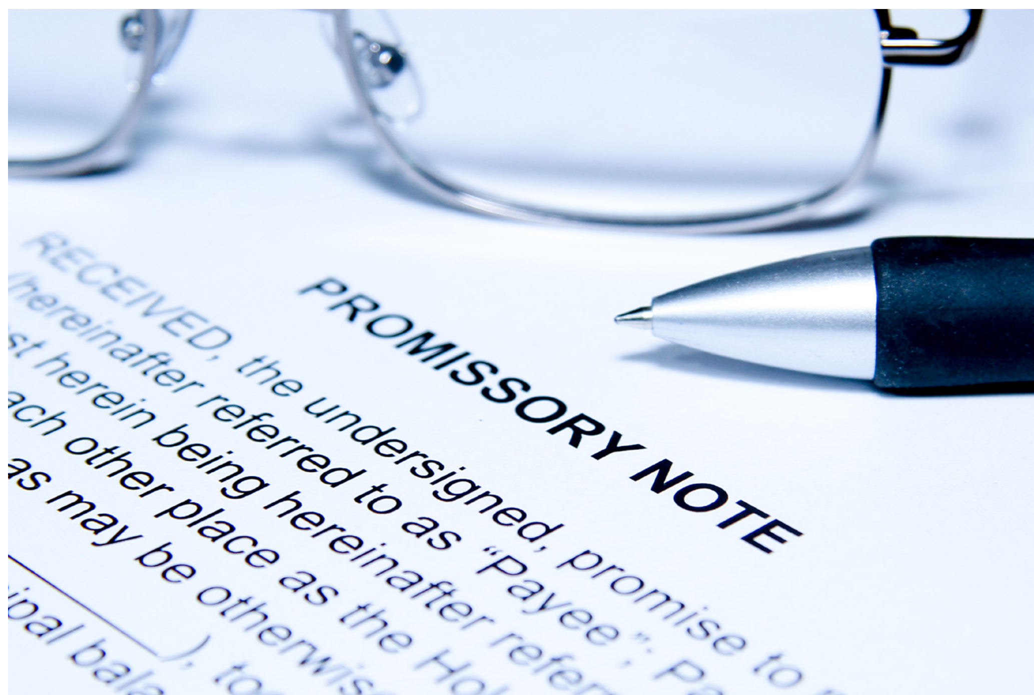
The analyst applied an expected eight-year maturity date, which could either be called a loan workout period or a renegotiated maturity extension. One valuation question is: In what future year would the parents most likely have the ability to repay, or begin repaying portions of, the principal of $50 million, as well as the beginning balance of accrued interest and annual interest payments?

An analyst could use a weighted average of several scenarios with different maturity dates or, if the taxpayer and its advisers have a good understanding of the future income of the obligor, an analysis could be as detailed as having the taxpayer pay off principal in several installments, rather than only at the end of the term.

Per the terms of the indenture, the Parent Note when in default carried an interest rate at the prime rate of 3.25 percent plus 3.00 percent, equalling a 6.25 percent interest rate.

Exhibit 4 shows the payments of annual interest as well as an assumption that the debtor repays outstanding accrued interest of $10 million in eight installments at the end of each year until maturity eight years later. The total payments of principal, interest, and accrued interest over eight years would be $87.3 million.

This figure exceeded the outstanding principal and accrued interest because interest is charged on the accrued interest balance as well as on the principal balance.



Next, a present value factor is applied to each total payment. The present value factor converts the selected risk-adjusted rate of 17.3 percent to a multiplier that incorporates the discounting period (in years) in the formula.

Each year's payment of principal, interest, and accrued interest is multiplied by the present value factor for that year.

The summation of the present value for each year results in the fair market value of the Parent Note, which was $34.2 million.

Because the selected market-based yield of 17.30 percent vastly exceeded the stated interest rate of 6.25 percent, the fair market value was substantially less than the outstanding principal and interest of $60 million.

Fair Market Value of the Children Notes—Recreation Holdings, LLC

One of the five notes held by the parents and exchanged with the Children's Holding Company was a note with debtor Recreation Holdings, LLC. The debtor was under slight, but not severe, distress and would likely delay payments on the outstanding accrued interest.

An analysis of historical and projected financial results, trends in occupancy rates, and the underlying industry indicated that the debtor would likely have the ability to pay outstanding accrued interest in two years, but would be able to pay annual interest on schedule.

A liquidation analysis revealed that the indicated fair market value of the total assets was significantly less than the fair market value of the note. The total assets included a leasehold interest with the U.S. Department of Interior.

Recreation Holdings, LLC, had obtained the leasehold and built many of its properties at the peak of the real estate bubble.

Exhibit 5 shows the characteristics of this note.

In this example, there is an index of hospitality bonds with duration that match the maturity date of this note. This market-based yield of 15.2 percent was selected. The note paid annual interest at the greater of 10 percent or the prime rate plus 4 percent. The note matures in 20 years.

Exhibit 6 presents the annual cash flow to the lender, with an assumption that accrued interest outstanding was paid over three years, as the real estate sector recovered.

The fair market value of this note was $20.2 million, compared to its outstanding principal and accrued interest of $32.8 million. The difference between the coupon rate and the risk-adjusted rate resulted in a significant discount from face value.

Technically, a hypothetical holder of this note could have declared the note in default and seized all assets. Would that action yield its highest and best use? Is it better to hold the note, or to seize the collateral?

The liquidation analysis is presented in Exhibit 7. Exhibit 7 summarizes what would have been multiple exhibits of analysis. Our liquidation analysis applies the adjusted net asset value method to arrive at the indicated fair market of total equity. This would have represented the entity's value in orderly liquidation, if the note holder were to exercise its right to declare the note in default.

Because the indicated value of total equity is approximately 50 percent of the fair market value of the note, the highest and best use of the note is, based on an analysis of Recreation Holdings, LLC, to continue to hold the note. An important consideration in doing so was that the parents had attached

Exhibit 5
Fair Market Value of Promissory Note
Owed by Recreation Holdings, LLC, to the Parents
Market Yield Based on Hospitality Index Rated B
As of February 18, 2010

Scenario 1:
(1) 20-Year Duration
(2) Based on Selected Hospitality Bond Index with Same Duration and Rated B

Outstanding Principal on Valuation Date ($)	30,000,000
Outstanding Accrued Interest on Valuation Date ($)	2,800,000
Outstanding Principal and Accrued Interest ($)	32,800,000
Maker/Debtor (obligor)	Recreation Holdings, LLC
Note Holder (obligee)	Parents
Security Interest	Secured by All Limited Liability Company Assets including Leasehold Interest
Valuation Date	2/18/2010
Issue Date	3/30/2009
Interest Rate (stated coupon per indenture)	10% (greater of 10% or prime rate plus 4%)
Type	Interest Only
Payment	Annually (compounded interest)
Maturity Date	3/30/2029
Assumption	Accrued Interest Paid Off during 2012, 2013, and 2014
Selected Risk-Adjusted Rate	**15.20%**
Risk-Adjusted Rate Based on →	BFV U.S. Hospitality (B rating, 20-year duration)

Exhibit 6
Fair Market Value of Promissory Note
Owed by Recreation Holdings, LLC, to the Parents
Market Yield Based on Hospitality Index Rated BBB
As of February 18, 2010

Payment Date	Principal and Accrued Interest $	Annual Interest $	Partial Period	Adjusted Annual Interest $	Payments of Original Accrued Interest $	Payments of Principal	Principal, Accrued Interest, and Annual Interest Payments $	Ending Principal and Accrued Interest $	Discounting Period	Present Value Factor 15.20%	Present Value of Total Payment $
3/30/2010	32,800,000	3,280,000	0.11	359,452	-	-	359,452	32,800,000	1.0	0.8681	312,024
3/30/2011	32,800,000	3,280,000	1.00	3,280,000	-	-	3,280,000	32,800,000	2.0	0.7535	2,471,547
3/30/2012	32,800,000	3,280,000	1.00	3,280,000	933,333	-	4,213,333	31,866,667	3.0	0.6541	2,755,931
3/30/2013	31,866,667	3,186,667	1.00	3,186,667	933,333	-	4,120,000	30,933,333	4.0	0.5678	2,339,308
3/30/2014	30,933,333	3,093,333	1.00	3,093,333	933,333	-	4,026,666	30,000,000	5.0	0.4929	1,984,647
3/30/2015	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	6.0	0.4278	1,283,531
3/30/2016	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	7.0	0.3714	1,114,176
3/30/2017	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	8.0	0.3224	967,167
3/30/2018	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	9.0	0.2799	839,555
3/30/2019	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	10.0	0.2429	728,780
3/30/2020	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	11.0	0.2109	632,622
3/30/2021	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	12.0	0.1831	549,151
3/30/2022	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	13.0	0.1589	476,693
3/30/2023	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	14.0	0.1379	413,796
3/30/2024	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	15.0	0.1197	359,198
3/30/2025	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	16.0	0.1039	311,804
3/30/2026	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	17.0	0.0902	270,663
3/30/2027	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	18.0	0.0783	234,951
3/30/2028	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	19.0	0.0680	203,950
3/30/2029	30,000,000	3,000,000	1.00	3,000,000	-	30,000,000	33,000,000	-	20.0	0.0590	1,947,441
				58,199,452	2,800,000	30,000,000	90,999,452				20,196,935
							Indicated Fair Market Value ($) (rounded)				**20,197,000**

Exhibit 7
Fair Market Value of Promissory Note
Owed by Recreation Holdings, LLC, to the Parents
Scenario 2—Liquidation
As of February 18, 2010

Scenario 2:

(1) Orderly Liquidation
(2) Based on Adjusted Net Asset Value Method

Outstanding Principal and Accrued Interest ($)		32,800,000
Maker/Debtor (obligor)		Recreation Holdings, LLC
Notes Holder (obligee)		Parents
Valuation Date		2/18/2010
Maturity Date		3/30/2029
Collateralized		Secured by All Limited Liability Company Assets including Leasehold Interest with U.S. Dept. of Interior
Fair Market Value of Total Assets ($)		15,000,000
Less: Discount for Exposure Period and Liquidation Costs ($)	-5%	(750,000)
Equals: Adjusted Net Assets Available as Collateral ($)		14,250,000
Indicated Fair Market Value ($) (rounded)		**14,250,000**

an allonge and guarantee to the note as part of the Exchange.

Although the fair market value of the primary real estate asset was less than the principal amount of the note, the allonge and guarantee covered the difference.

The reason the fair market value of equity was negative (assets of $14.25 million, debt of $32.8 million) was that the entity acquired a leasehold and developed luxury property, using the note as capital, at the peak of the real estate sector's cycle.

Fair Market Value of the Children Notes—Insurance Holdings, LLC

The purpose of this entity was to hold life insurance policies on the parents for the benefit of the children. It was funded with loans both from banks and the parents.

The banks were owed $11 million and the parents were owed $5.2 million. The banks were senior lenders and the parents were subordinated lenders. The note held by the parents was part of the Exchange.

Exhibit 8 presents the assets of Insurance Holdings, LLC, at fair market value. Exhibit 8 presents the pecking order of claims, should the rights to this demand note be exercised.

The fair market value of the life insurance policies was equal to their interpolated terminal reserve values. If the entity were liquidated, it could meet the obligation to the note holder.

The fair market value of this note is presented in Exhibit 9. Because this is a demand note, with no maturity date, selecting an appropriate maturity date depends on the facts and circumstances of the case.

This example presented a fair market value under the assumption that the holder would exercise their right to demand payment of principal, and that this would take three months to complete orderly liquidation of the assets of Insurance Holdings, LLC.

In this example, the analyst received documentation showing untimeliness of the payment of insurance premiums. After further analysis of the financial status of the capital contributors (other than banks) to this entity, the analyst concluded that a rational investor would, more likely than not, seek to recoup his or her loan as soon as possible.

Exhibit 8
Insurance Holdings, LLC
Fair Market Value of Assets and
Hypothetical Payments of All Obligations Upon Demand
As of February 18, 2010

	Fair Market Value as of 3/31/09 $
ASSETS	
Current Assets:	
Cash and Cash Equivalents	6,000,000
Total Current Assets	6,000,000
Long-Term Assets:	
Life Insurance Policy #1	5,000,000
Life Insurance Policy #2	500,000
Life Insurance Policy #3	4,000,000
Life Insurance Policy #4	700,000
Life Insurance Policy #5	500,000
Total Long-Term Assets	10,700,000
TOTAL ASSETS	16,700,000
Order of Claims by Obligees Against Assets	
Assets Liquidated at Fair Market Value	16,700,000
Less: Obligations to Bank Lenders	(11,000,000)
Equals: Remaining Assets Available to Note Owed to the Parents	5,700,000
Less: Note Owed to the Parents	(5,200,000)
Equals: Remaining Assets	500,000

The note could be repaid based on the value of the total equity of the borrower in orderly liquidation.

Another factor considered was that the nonoperating entity generates zero cash flow from selling any goods or services. The entity's assets produce no cash flow until an unknown date of death (no visibility) that unlocks the full value of the policies.

There were uncertainties over this entity's ability to pay note principal on demand and, in its operating role, pay insurance premiums.

The principal of the note cannot be repaid unless all insurance policies are paid upon death, whenever that is, or sold in a secondary transaction. The value of the entity in orderly liquidation is based on selling the insurance policies in secondary transactions.

Fair Market Value of the Children Notes—Owed to Parents by Business Associate

The parents lent their business associate $5 million approximately three and one-half years before the Exchange. The loan was secured by various parcels of real estate, some were land for residential development; some were already developed.

The business associate owed accrued interest of $1 million, had not been making timely payments, and was severely delinquent past the maturity date. The selected maturity date for this note was based on the time for orderly liquidation of the collateral assets.

A real estate appraiser appraised the properties. The real estate appraisal report was provided to the analyst by taxpayer's counsel.

Exhibit 10 presents the fair market value of total assets that served as collateral. In an orderly liquidation, after estimated transaction costs of 5 percent, there is sufficient value attributable to exercising one's rights as the holder of a demand note and recoup the principal.

Exhibit 11 applies a market-based yield based on the one-year Treasury bill rate. For the sake of simplicity, this illustration applies a risk-free rate.

Exhibit 9
Fair Market Value of Promissory Note
Owed by Insurance Holdings, LLC, to Parents
Multiple Advance Promissory Note—Not to Exceed $10 Million
As of February 18, 2010

Outstanding Principal on Valuation Date ($)	5,000,000
Outstanding Accrued Interest on Valuation Date	200,000
Total Principal and Accrued Interest ($)	5,200,000
Maker/Debtor (obligor)	Insurance Holdings, LLC
Note Holder (obligee)	Parents
Valuation Date	2/28/2010
Issuance Date	6/22/07
Interest Rate	4.91% (long-term applidable federal rate per note indenture)
Type	Interest Only
Payment	Annually
Maturity Date	On Demand
Collateralized	Yes

Selected Risk-Adjusted Rate **0.19%** → 90-Day U.S. Treasury Bill Rate

Payment Date	Beginning Principal and Accrued Interest	Annual Interest	Partial Period	Adjusted Annual Interest	Payments of Principal and Accrued Interest	Ending Principal and Accrued Interest	Total Payment	Discounting Period	Present Value Factor 0.19%	Present Value of Total Payment
	$	$		$	$	$	$			$
5/30/2010	5,200,000	255,320	0.25	63,655	5,200,000	-	5,263,655	0.2493	0.9995	5,261,023

Indicated Fair Market Value ($) (rounded) **5,261,000**

Since the assets to be liquidated were real estate properties, a more appropriate risk-adjusted rate may have been tied to the real estate sector.

The analysis assumes that all properties were under contract at fair market value as of the date of the Exchange. Furthermore, as with all the Children Notes, this note was accompanied by an allonge and guarantee from the parent's trusts.

The original maturity date was December 31, 2007, and the note was in default. Per the note indenture, the lender had the right to take title to the collateral.

This example assumes that it takes one year to receive proceeds from the sales of properties and that each property's proceeds are paid exactly one year after the date of the Exchange.

Exhibit 10
Fair Market Value of Promissory Note
Owed to the Parents by the Business Associate
Summary of Fair Market Value of the Collateral
As of February 18, 2010

Property	Fair Market Value $
Apartment Complex	1,500,000
Land for Residential Development	600,000
Apartment Complex	3,000,000
Land for Residential Development	100,000
Land for Residential Development	350,000
Land for Residential Development	400,000
Land for Residential Development	500,000
	6,450,000

Liquidation of the Collateral	Payment of Principal and Accured Interest
Assets Liquidated at Fair Market Value	6,450,000
Less: Transaction Costs at 5.0 Percent	(322,500)
Equals: Proceeds from Sales of Properties	6,127,500
Less: Principal and Accrued Interest Owed to the Parents	(6,000,000)
Equals: Surplus/(Deficiency) in Assets Available	127,500

Fair Market Value of the Children Notes—Owed by Son to Parents

In 2003, the son obtained a loan from the parents in the amount of $1.5 million. The purpose of the loan was for the purchase

Exhibit 11
Fair Market Value of Promissory Note Owed to the Parents by the Business Associate As of February 18, 2010

Outstanding Principal on Valuation Date ($)	5,000,000	
Outstanding Accrued Interest on Valuation Date ($)	1,000,000	
Total Principal and Accrued Interest ($)	6,000,000	
Maker/Debtor (obligor)	Business Associate of Parents	
Note Holder (obligee)	Parents	
Valuation Date	2/18/2010	
Issuance Date	10/2/06	
Interest Rate	5.25%	(prime rate of 3.25 percent plus 2.00 percent)
Type	Interest Only	
Payment	Annually	
Maturity Date	12/31/2007	
Collateralized	Yes	
Selected Risk-Adjusted Rate	**0.44%**	→ 1-Year U.S. Treasury Bill Rate

Payment Date	Beginning Principal and Accrued Interest $	Annual Interest $	Partial Period	Adjusted Annual Interest $	Payments of Principal and Accrued Interest $	Total Payment $	Discounting Period	Present Value Factor 0.44%	Present Value of Total Payment $
2/18/2011	6,000,000	315,000	1.00	-	6,000,000	6,000,000	1.00	0.9956	5,973,600

Indicated Fair Market Value ($) [rounded] **5,974,000**

Exhibit 12
Fair Market Value of Promissory Note Owed by the Son to the Parents As of February 18, 2010

Original Principal Amount ($)	1,500,000
Outstanding Principal on Valuation Date ($)	1,500,000
Outstanding Accrued Interest on Valuation Date ($)	12,000
Maker/Debtor (obligor)	Son
Note Holder (obligee)	Parents
Valuation Date	2/18/2010
Issuance Date	12/1/2003
Interest Rate	4.01% (short-term applicable federal rate per note indenture)
Type	Interest Only
Payment	Annually
Maturity Date	12/31/20010
Collateralized	Yes (real estate)
Selected Risk-Adjusted Rate	**5.00%** → Average Mortgage Rate per Freddie Mac

Payment Date	Beginning Principal and Accrued Interest $	Annual Interest $	Partial Period	Adjusted Annual Interest $	Payments of Principal and Accrued Interest $	Ending Principal and Accrued Interest $	Total Payment $	Discounting Period	Present Value Factor 5.00%	Present Value of Total Payment $
12/31/2010	1,512,000	60,631	0.87	52,491	1,512,000	-	1,564,491	0.8658	0.9586	1,499,722

Indicated Fair Market Value ($) [rounded] **1,500,000**

Exhibit 13
Fair Market Value of Promissory Note Owed by the Daughter to the Parents As of February 18, 2010

Original Principal Amount ($)	1,500,000
Outstanding Principal on Valuation Date ($)	1,500,000
Outstanding Accrued Interest on Valuation Date ($)	12,000
Maker/Debtor (obligor)	Daughter
Note Holder (obligee)	Parents
Valuation Date	2/18/2010
Issuance Date	8/1/2004
Interest Rate	3.78% (short-term applicable federal rate per note indenture)
Type	Interest Only
Payment	Annually
Maturity Date	12/31/2010
Collateralized	Yes (real estate)
Selected Risk-Adjusted Rate	**5.00%** → Average Mortgage Rate per Freddie Mac

Payment Date	Beginning Principal and Accrued Interest $	Annual Interest $	Partial Period	Adjusted Annual Interest $	Payments of Principal and Accrued Interest $	Ending Principal and Accrued Interest $	Total Payment $	Discounting Period	PV Factor 5.00%	PV of Total Payment $
12/31/2010	1,512,000	57,154	0.87	49,481	1,512,000	-	1,561,481	0.8658	0.9586	1,496,836

Indicated Fair Market Value ($) [rounded]	**1,500,000**

of a lot, which the son developed into a successful rental property. This note was secured by the property and matures in less than a year after the Exchange date.

Exhibit 12 presents the inputs and calculations to arrive at its fair market value.

The market-based yield was the average mortgage rate per Freddie Mac of 5 percent—not much higher than the coupon rate in the indenture. The note matures less than a year after the Exchange.

To assess the risk of principal being paid, the analyst observed that the son was able to access his trust, as a beneficiary, to meet principal and interest payments if necessary. The son's trust agreement authorizes the trustee to make distributions for expenses including health, education, maintenance, and support. It also allows the son, as settlor, to revoke the trust and provides that all the trust property would revert back to the son. Therefore, the son had full access, at any time, to the assets of this trust.

As of the date of the Exchange, the son's trust had total assets with a stated value of $75 million, total liabilities of $25 million, and corpus of $50 million. The assets consisted of the following:

1. Publicly traded stock in XYZ Inc. with a stated value of $50 million
2. An equity interest in privately held ABC Inc. with a stated value of $20 million
3. A note receivable with a stated value of $5 million

The analyst also considered the timeliness of interest payments for the note.

The fair market value of the note was equal to its outstanding principal and accrued interest.

Fair Market Value of the Children Notes—Owed by Daughter to Parents

In 2004, the daughter obtained a loan from the parents in the amount of $1.5 million to purchase a home. This note was secured by the property and matures in less than a year after the Exchange date.

Exhibit 13 presents the inputs and calculations to arrive at its fair market value.

The only difference from the note owed by the son is the stated interest rate based on the short-

Exhibit 14
Assets Exchanged between the Parents and the Children's Holding Company
Summary of Concluded Fair Market Values
As of February 18, 2010

Assets Received by Children's Holding Company:		Assets Received by Parents:	
Promissory Notes Held by Parents		*Promissory Note Held by Children's Holding Company*	
Debtor	Fair Market Va;ie $	Debtor	Fair Market Value $
Recreation Holdings, LLC	20,197,000		
Insurance Policy Holdings, LLC	5,261,000		
Business Associate of Parents	5,974,000		
Son	1,500,000		
Daughter	1,500,000	Parents	34,207,000
Total FMV of Promissory Notes	34,432,000		34,207,000
Fair Market Value of Assets Exchanged	**34,432,000**	**Fair Market Value of Asset Exchanged**	**34,207,000**

Fair Market Value of Assets Received by Childrens' Holding Company	34,432,000
Less: Fair Market Value of Asset Received by Parents	(34,207,000)
Equals: Taxable Gift by Parents to Children's Holding Company ($) [rounded]	**225,000**

term applicable federal rate at the time the note was issued. The daughter had the same access to her trust and same level of net assets at her behest.

The note owed by the daughter had a fair market value of $1.5 million.

Actual Gift Size Based on Opinions of Fair Market Value

This example illustrates the valuation of the notes and opinions of fair market value. Now, the analysis sums up the fair market values on each side of the Exchange to see how much of a gift was made.

Exhibit 14 calculates the fair market values of the assets and concludes with the size of the taxable gift.

The Service's notice of deficiency alleged there was a taxable gift in the amount of $13 million owed by the Children's Holding Company because the nominal value of the note given to the parents exceeded the sum of the nominal values of the notes given by the parents to the Children's Holding Company by $13 million.

Based on a fair market value analysis, the Parent Note was worth $225,000 less than the aggregate fair market value of the Children Notes. This amount was determined to be the gift. Instead of the Children's Holding Company owing gift tax on $13 million, the parents owe gift tax on $225,000.

Summary and Conclusion

After thorough analysis of all the notes involved with the Exchange, the taxpayers and the Service agreed that the value gap (the gift), based on the relative fair market values, was only $225,000 (compared to the alleged $13 million fair market value calculated by the Service). Also, rather than the Children's Holding Company owing the gift tax, it is the parents who owed the gift tax.

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