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CLAREMONT McKENNA COLLEGE

IMPACT OF THE FEDERAL ESTATE TAX ON THE L.A. DODGERS

SUBMITTED TO

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AND

DEAN GREGORY HESS

BY MARK GOSE

FOR

SENIOR THESIS

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Introduction

"The time is approaching when a family cannot support a major-league baseball team," said Peter O'Malley, the former owner of the Los Angeles Dodgers, "It is the time of corporate ownership" ("Baseball Economics"). O'Malley's foreboding remarks were made during a press conference at Dodger Stadium in 1998. At that time, Congress had imposed an estate tax with a top rate of 55%, which placed a serious burden on O'Malley. This savvy businessman knew that since the Dodgers franchise generates minimal income, his children would not have enough funds to pay the high estate tax and maintain ownership of the team after his death ("Baseball Economics"). As a result, he decided to sell the Dodgers to Fox Entertainment Group in 1998 – 48 years after his father, Walter O'Malley, became President of the team (Bloom). From a business standpoint, he made the optimal decision that would maximize the future wealth of his family. However, had the federal government significantly lowered or eliminated the estate tax, selling such a valuable family asset to a large corporation would most likely have never even crossed his mind.

After six unsuccessful years of management, Fox Entertainment Group sold the Dodgers to real estate developer Frank McCourt in 2004 for $430 million (Bloom). McCourt, who has been the owner for the past seven seasons, has expressed a desire to eventually pass the team on to his four sons (Dilbeck). Like O'Malley, he must decide whether that will be a viable option given the prevailing estate tax. Although the tax has been repealed in 2010 (that is, all estates are currently exempt), if Congress does nothing to change the existing law, the Bush Tax Cuts will expire in 2011, which will push the top rate back up to 55% (Block).

Assuming McCourt wins full ownership of the Dodgers (he is going through a divorce right now), he must address this critical question: is the organization generating enough after-tax income that would allow his sons to pay off the estate tax without having to sell the team after his death? If not, are there any feasible strategies that Frank could implement to allow his sons to maintain ownership of the team?

After a summary of the history and proposed legislation of the estate tax, this paper will seek to answer these two questions by using a hypothetical situation with respect to the tax rates and McCourt's estate, which I will assume for the sake of argument to be solely the Dodgers franchise. The insight provided by this example will not only underscore the impact this tax has on the decision making for family-run businesses but also offer certain tax-planning strategies for minimizing this burdensome tax.

Estate Tax History and Current Legislation

Also known as the "death tax," the federal estate tax is defined as "a tax on your right to transfer property at your death. It consists of an accounting of everything you own or have certain interests in at the date of death" ("Estate Taxes"). Governments generating revenue from the taxation of property transferred at death dates back to ancient civilization. Records show that in 700 B.C, the Pharaoh of Egypt levied a 10% excise tax on assets transferred at death, and Emperor Caesar Augustus imposed a tax on legacies and successions during the Roman Empire (Robbins).

The U.S. Government carried on this tradition of using death taxes as a source of funding with the establishment of the Stamp Act of 1797, which required federal stamps to be purchased when transferring property from an estate (Fleenor). The stamps applied to wills and letters of administration in probate and varied in cost depending upon the value of the estate and the size

of the transfer (Fleenor). In response to a crisis overseas with France, Congress enacted the stamp tax as a way to raise revenue for the creation of a Navy (Robbins). After the controversy subsided in 1802, the tax was repealed and this Act "set a pattern for the next hundred years in which death taxes were used as a sporadic and temporary way to finance wars" (Robbins).

In order to support the cost of the Civil War, for example, Congress instituted the Revenue Act of 1864, which imposed an inheritance tax on personal property transferred from a decedent's estate (Fleenor). Unlike the stamp tax, which was based on the value of the estate and size of transferred property, the inheritance tax rates "were graduated based on the beneficiaries relationship to the decedent" (Jacobson, Raub, and Johnson). Due to escalating debt, Congress established the Revenue Act of 1864, which modified the 1862 Act to include "a succession tax- a tax on bequests of real estate – and an increase in legacy rates" (Jacobson, Raub, and Johnson).

Less than 20 years later, the U.S. was on the brink of another war and again relied on a death tax for additional financing -- Congress reinstated an inheritance tax through the War Revenue Act of 1898 (Robbins). However, this tax differed from the previous two federal death taxes levied during times of war in that "it was a duty on the estate itself, not on its beneficiaries" (Jacobson, Raub, and Johnson). Despite being repealed shortly after the war, this legacy tax served as the foundation to the modern-day estate tax, which Congress officially adopted under the Revenue Act of 1916 (Fleenor).

Since this Act, the federal estate tax has served as a permanent source of revenue for the U.S. Government (Robbins). Like the 1898 tax, the modern-day estate tax is levied on the estate itself as opposed to on the beneficiary (Jacobson, Raub, and Johnson). The federal estate tax applies to the value of the net estate, that is, the fair market value of everything one owns less allowable deductions ("Estate Taxes"). Rates at that time were graduated "from 1 percent on the

first 50,000 to 10% on the portion exceeding $5 million" (Jacobson, Raub, and Johnson). Further, a $50,000 exemption was permitted for U.S. residents. Though in order to generate more revenue to support World War I efforts, Congress raised the marginal rates to 2 percent on the first $50,000 and 25% on the amount in excess of $10 million. Instead of repealing the tax at the end of the War, Congress simply lowered the rates on estates of less than $1 million (Jacobson, Raub, and Johnson).

Over time, the government began to view the death tax as a mechanism for redistributing wealth across society, which led Congress to increase rates over the next 50 years (Fleenor). In particular, from 1935-1981 rates were consistently set as high as 70% or greater on estates in the top bracket (Robbins). Though the estate tax exemption allowed for decedents also went up during this period. Congress enacted a $60,000 exemption between 1942-1976, but with the passage of the Tax Reform Act of 1976, Economic Recovery Act of 1981, and the Taxpayer protection Act of 1997, the exemption increased to a respective, $120,000, $600,000, and $1 million (Jacobson, Raub, and Johnson). Another important aspect of the 1981 Act is that it reformed the 1976 Act by establishing an unlimited marital deduction (Jacobson, Raub, and Johnson). In other words, the estate can now deduct the full value of the property transferred to a surviving spouse, and therefore, is technically exempt from the tax. In effect, in the case of married taxpayers the estate tax is now generally only imposed after the second spouse dies (IRC section 2056(a)).

In a first attempt to eliminate the federal estate tax, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (Prince). This piece of legislation set forth gradual reductions of the maximum estate tax rate from 55% in 2001 to 45% in 2009 and periodic increases in the estate exemption from $1 million to eventually $3.5 million in 2009

(Prince). More importantly, this Act mandated the repeal of the estate tax in 2010. Unless Congress reinstates the estate tax retroactively as of January 1st, 2010, all decedents who die this year will be exempt from the estate tax but subject to the modified carryover basis regime under (I.R.C. section 1022).

Prior to the inception of this modified carryover basis regime, property transferred from a decedent's estate would receive a step-up in basis to the fair market value of the property on the date of the decedent's death (IRC section 1014). That way the beneficiary, upon eventually selling the asset, did not have to pay a capital gains tax on the appreciation that occurred prior to the decedent's death. However, with the passing of the carryover basis rule in 2010, "the basis of the person acquiring property from a decedent dying after December 31, 2009 shall be the lesser of the adjusted basis of the decedent or the fair market value of the property at the date of the decedent's death" (IRC section 1022). The adjusted basis in an asset is the original cost of an asset on the date of purchase or acquisition plus any capital improvements minus deductions for depreciation or amortization ("Basis of Assets"). Consequently, despite the absence of an estate tax, a beneficiary could still face a capital gains tax upon the sale of the inherited asset. In order to prevent this rule from placing an undue burden on individuals, I.R.C. section 1022 permits an automatic step-up in basis of $1.3 million and an additional $3 million step-up in basis for assets passed on to a surviving spouse. With respect to Frank McCourt's estate, however, this step-up is insignificant, and the carryover basis rule could possibly lead to a higher tax liability than the estate tax would if Frank McCourt were to pass away in 2010.

In 2011, under the Economic Recovery and Tax Reconciliation Act of 2001, the estate tax is set to revert back to its 2001 status (rate of 55% on estates in the top bracket and a $1 million exemption) (Jacobson, Raub, and Johnson). However, there are currently two proposals

in Congress that would increase the exemption and decrease the rates. One proposal is to reinstate the 2009 levels (top rate of 45% with an exemption of $3.5 million), and the other proposal, which is receiving bipartisan support in the Senate, is to lower the top rate on estates to 35% and increase the exemption amount to $5 million (Sahadi). President Obama's budget is calling for the permanent restoration of the 2009 levels (Block).

Projection of Future Cash Flows and Team Valuation

One of the main objectives of this paper is to determine whether or not McCourt's sons will have enough after tax cash flow from the Dodgers franchise (assuming that this is their sole source of income) to pay off the estate tax after their father's death. This involves estimating the team's future after tax cash flows and the value of the franchise going forward (I will assume both of these amounts to be constant), which will allow for the calculation of McCourt's gross adjusted estate and the related estate tax liability.

Using the Dodgers' income statements from 2006-2009 (disclosed in the Los Angeles Times due to Frank and Jamie McCourt's divorce), I computed the average total operating income of these prior four years to derive an approximation of the Dodger's future operating income starting in 2010. As shown in exhibit 1, the projected operating income is $27.8 million. In order to find the Dodgers' future pre-tax cash flow, I added miscellaneous income (based on prior four year average) to the projected operating income and subtracted out the $24 million interest payment (see exhibit 1 footnote), which amounted to a future pre-tax cash flow of $11.1 million. In addition, since McCourt pays himself a $5 million salary (Kriegel), his sons could add back $3 million to pre-tax cash flows after his death (based on the assumption that the sons would each receive an annual salary of $500,000). Therefore, the adjusted future pre-tax cash flow is assumed to be $14.1 million (see exhibit 2).

With respect to the value of the Dodgers franchise, Forbes published an article that estimated the value of the Dodgers in 2008 and 2009 to be $694 million and $727 million, respectively (see exhibit 3) (Forbes). Based on the estimates in those articles of the annual gross revenue, Forbes was utilizing an average gross revenue multiple of 3.02 over those two years (see exhibit 3). Accordingly, to determine the value of the Dodgers for purposes of this paper, I multiplied the franchise's projected revenue of $271.7 million (based on the four year average reported in the LA times) by 3.02, which yielded a future team value of $820.5 million (I then rounded to $800 million).

Forbes estimates that Dodger stadium constitutes 25% of the team value, so I assumed that approximately 75% is allocable to intangibles. As explained in IRS publication 535 (2009), any intangible asset acquired in connection with a professional sports franchise (including player contracts) is an IRC section 197 intangible asset amortizable over a 15-year period. Therefore, upon the inheritance of the franchise, the sons can amortize and deduct approximately $40 million per year (75%*$800 million/15 years). This is because even if Frank McCourt's tax basis in the franchise was zero, after 2010 upon Frank McCourt's death, they will receive a step-up in basis under IRC section 1014(a)(1) to the fair market value of the team (assumed to be $800 million) and would be entitled to section 197 amortization. Without even considering additional deductions like depreciation of the stadium, the amortization of the intangible assets would completely shelter the Dodgers' taxable income for at least 15 years. As reflected in exhibit 4, the Dodgers would generate an annual taxable loss of $23.9 million. Because the Dodgers would not have to pay income taxes for several years after their father's death, the sons would have the entire amount of the Dodgers' adjusted future pre-tax cash flow ($14.1 million per year) for purposes of paying of the estate tax.

Exhibit 1

Dodgers Financials (in millions)	**2006**	**2007**	**2008**	**2009**	**2010-future**
Revenues					
Gate receipts	87.5	104.2	111.0	107.2	102.5
Local broadcast	39.1	40.1	39.3	41.5	40.0
Concessions	24.4	26.7	24.1	25.5	25.2
Advertising	21.2	24.0	26.1	27.0	24.6
Parking	9.2	12.2	12.0	11.0	11.1
Suite Rentals	14.0	19.7	20.5	20.0	18.6
Postseason	2.0	0.0	6.6	6.7	3.8
Other local	1.2	2.0	7.5	4.5	3.8
National	40.9	43.4	41.9	42.6	42.2
Total Revenues	239.5	272.3	289.0	286.0	**271.7**
Expenses					
Player compensation	107.3	125.6	125.9	128.4	121.8
Player benefit plan	4.0	4.9	5.0	5.1	4.8
Team operations	13.7	14.1	18.2	18.5	16.1
Insurance policy recoveries	(3.4)	(2.9)	(8.7)	(16.3)	(7.8)
Player development	18.9	18.2	18.1	15.0	17.6
Stadium operations	22.9	25.9	27.1	27.0	25.7
Marketing	8.3	7.7	10.8	11.0	9.5
General administrative	16.3	21.7	22.4	20.0	20.1
MLB central fund	4.1	5.1	6.5	5.1	5.2
Total Expenses	192.1	220.3	225.3	213.8	**212.9**
Operating Income					
OI before revenue sharing	47.4	52.0	63.7	72.2	58.8
MLB revenue sharing payment	(26.9)	(24.1)	(38.8)	(34.3)	(31.0)
Total Operating Income	20.5	27.9	24.9	37.9	**27.8**
Adjustments					
Misc. income	16.1	4.9	4.7	3.6	7.3
Interest payments	(3.5)	(4.9)	(33.6)	(28.0)	(24)[1]
Total Adjustments	12.6	0.0	(28.9)	(24.4)	**(16.7)**
Pre-Tax Cash Flow	$33.1	$27.9	-$4.0	$13.5	**$11.1**

Exhibit 2

Pre-Tax Cash Flow (date of death - future)	
Pre-tax cash flow based on prior years' average	11.1
Add back part of McCourt's annual salary	3.0
Adjusted Pre-Tax Cash Flow	**$14.1**

[1] The interest payment is not based on the prior four-years average because the low payments in 2006 and 2007 would understate the average amount of interest owed in the future. I assume Frank McCourt's debt to be $400 million (50% of the Dodgers franchise value) on his date of death, so at an interest rate of 6% (an approximate cost for such a large commercial loan) the sons will owe $24 million in annual interest payments (steelheadcaptial.com).

Exhibit 3

Forbes Valuation of Dodgers (2008)
Team Value: $694 million Gross Revenue Multiple: 2.94 times revenue
Forbes Valuation of Dodgers (2009)
Team Value: $727 million Gross Revenue Multiple: 3.09 times revenue
My Valuation (2010-future)
Projected revenue (2010-future): $271.7 million (exhibit 1) Average gross revenue multiple of past two years: 3.02 **Value: $820.5 million = approximately $800 million**

Exhibit 4

Taxable Income (date of death + at least 15 years)	
Adjusted pre-tax cash flow	16.1
Less: amortization of intangible assets	40.0
Taxable Income	**$(23.9)**

Estate Tax Liability and Installment Plan (IRC section 6166)

This paper will assume for the sake of argument that McCourt will die in a year when the estate tax rate and exemption are equivalent to what they were in 2009. It will also assume as discussed previously that the Dodgers have a value of $800 million and a debt load of $400 million (according to Forbes, debt represents approximately 50% of the team value). Based on these assumptions, exhibit 5 below calculates the projected estate tax liability if Frank McCourt were to die in 2011.

Exhibit 5

Team Value	$800 mil
Less Debt	$400 mil
Gross Adjusted Estate	$400 mil[2]
Estate tax rate	45%
Federal estate tax liability	**$180 mil**

[2] This amount is marginally overstated due to my exclusion of administrative expenses and the standard exemption of $3.5 million. However, such a small deduction for an estate worth $800 million is not going to make much of an impact on the overall estate tax liability.

Assuming that McCourt's sons have no other sources of income besides the Dodgers franchise, they will not be able to pay the lump sum of $180 million dollars given that the team only generates an estimated $16.1 million per year. However, under I.R.C. section 6166, the sons can elect to pay off the tax under an installment plan. I.R.C. section 6166 specifies that if the value of interest in the business included in determining gross estate of decedent exceeds 35% of gross adjusted estate, then the executor may elect to pay interest only on the tax liability for four years after the return date (the return is due 9 months after death) and then pay the tax liability plus interest on a ten-year installment basis. Since this paper assumes that the value of the Dodgers franchise represents McCourt's entire estate, the sons will be eligible for this extended payment plan. There are two interest rates that apply: 2% on the first million (which for simplicity I will ignore for calculating the annual payment) and then 45% of the interest rate charged on the underpayment of taxes, currently about 1.54%,[3] applied to the balance. After the four-year deferral with minimal interest, the sons will be subject to an annual payment of $19,433,088 (Bankrate.com).

As evidenced from the calculation, the sons will not be able to pay off the estate tax under the installment plan given an estimated annual cash flow of only $16.1 million. However, if McCourt were to implement certain tax planning strategies, perhaps the tax burden could be reduced so that his sons would be able to pay off the tax after his death.

Tax Planning Strategies

The following estate-planning options are viable ways that McCourt can ease the estate tax burden on his sons: a grantor retained annuity trust (GRAT), an intentionally defective irrevocable trust (IDIT), a private annuity, and an irrevocable life insurance trust (ILIT). With

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[3] 45% x (October 2010 underpayment rate of 0.41% cited by Evans + 3% under IRC section 6621(a)(2).

the exception of the ILIT, a key component to these techniques is the availability of the valuation discounts for gifts or sales of interests (in this case, stock or other ownership interests in the Dodgers) where the interests transferred involve limitations on control and/or marketability. Consequently, I will begin with a discussion of valuation discounts.

Valuation Discounts

If a buyer purchases a partial interest in a property (whether real estate or business interest), he is not going to be willing to pay a pro-rata price for the interest. In other words, if a 100% interest in a business is valued at $1 million, a buyer is not going to pay $490,000 for a 49% interest in the business. He will demand a discount for the fact that he lacks control of the company (a “lack of control” discount) and because a partial interest in a business is much more difficult to sell than a full interest (a “lack of marketability” discount) (Ransome, and Satchit).

Due to this reality, in the event that a taxpayer gifts or sells a minority interest in his business to a family member or an irrevocable trust for estate planning purposes, the IRS allows the taxpayer to discount the value of the transferred interest (Ransome, and Satchit). The size of the discount is usually based on expert appraiser opinions. But, if a dispute ever arises between the taxpayer and the IRS, the United States Tax Court often settles the issue. Based on various court cases, the discount seems to range from 15-60% (Hopson).

Ultimately, these available valuation discounts make the GRAT, IDIT, and private annuity significantly more effective for estate planning. I will discuss each of these techniques in the following section.

Grantor Retained Annuity Trust (GRAT)

In a GRAT arrangement, a taxpayer transfers business interests (i.e. stock or limited liability company (LLC) interests) into an irrevocable trust in exchange for a fixed annuity payment due over a specified term (Lincoln Financial Group).[4] The calculation of the annuity amount is based on several factors, including term length, the dollar amount of the annuity payable, the age of the grantor on the date of transfer, and the applicable interest rate under IRC section 7520 (120% of annual mid-term AFR) (Pierce Atwood LLP). Upon the initial creation of the GRAT, if the value of the transferred business interest exceeds the present value of the annuity payments, the difference is treated as a gift and will be taxed accordingly (Rev. Rul. 2004-64). However, given the low applicable interest rate (1.9% as of November 2010)(Evans), it is fairly easy to structure the annuity payments so that the present value of the annuity and the value of the business interest will be equal (referred to as a "Zero-GRAT") (Giarmarco). In that case, when the specified trust term expires, the gifted business interest will pass on to the beneficiaries of the trust free of any gift tax consequences to the taxpayer (Bannon). Of course, the taxpayer's estate will be replenished by the annuity payments he receives each year, but it is likely that what the business interest will earn while being held in the trust will exceed the annual annuity payments. Consequently, this excess cash flow can pass on to the beneficiaries free of any gift or estate tax liability upon the expiration of the trust (Bannon).

Another benefit is that any appreciation of the business interest that occurs after the interest is transferred to the trust will be excluded from the taxpayer's estate (Giarmarco). In the event that the business interest significantly goes up in value, a taxpayer's estate savings could

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[4] Because the sale is between the taxpayer and his grantor trust, the IRS does not recognize any gain or loss on the sale (Rev. Rul. 85-13).

be substantial. Also, the taxpayer is liable for paying income taxes on all of the trust's earnings (Rev. Rul. 2004-64), so more dollars will accumulate in the trust estate tax-free.

Furthermore, valuation discounts can be applied to the business interest transferred into the GRAT, which can make this technique even more valuable. For example, if McCourt were to transfer a 40% non-voting interest into the GRAT, he could probably justify taking a discount in the 40% range for the gift (due to "lack of marketability" and "lack of control"). This discounted amount would essentially be removed from McCourt's estate without any gift or estate tax consequences.

The downside is that if the taxpayer does not survive the annuity term, then the GRAT fails because the entire value of the business interest in the trust will be transferred back into the taxpayer's estate (Brown). President Obama has proposed a budget for 2011 that would require the GRAT to have a term of at least 10 years, which of course increases the risk that the taxpayer will die prematurely (Kaplan).

Intentionally Defective Irrevocable Trust (IDIT)

Like a GRAT, the IDIT is designed to accomplish the same tax-planning objectives, including benefiting from the low-tax environment, removing the appreciation of the transferred interest from the taxpayer's estate, and taking advantage of the valuation discounts. The primary difference is that rather than gifting a business interest in exchange for an annuity, an IDIT involves selling a business interest to an irrevocable trust (Brown).

Under the IDIT structure, a taxpayer is required to contribute an initial seed payment (10% of the value of the business interest sold) to the trust to "ensure the trust is deemed a bona-fide purchaser of the transferred asset" ("IDIT"). The taxpayer then sells a portion of his business

interest to the trust in exchange for an interest-bearing promissory note (Bannon).[5] The note can be interest only, which can limit the amount of annual payments that must be made to the taxpayer. Also, with the applicable interest rate being so low, it is likely that cash flow generated by the business interest in the trust will exceed the interest payments made to the taxpayer (Brown).[6] As in a GRAT arrangement, this excess in earnings will pass on to the beneficiaries of the trust without any gift or estate tax consequences to the taxpayer. And the taxpayer, not the trust, recognizes all the earnings generated by the transferred business interest (IRC section 671), so more income will be left in the trust to build-up estate tax free. Additionally, any appreciation of the transferred business interest (while being held in the trust) will be excluded from the taxpayer's estate (Bannon).

Like in the GRAT, the purchase price of the business interest sold to an IDIT can also be discounted for lack of marketability and lack of control factors. In effect, this discount lowers the value of the promissory note that the trust must give to the taxpayer (Lincoln Financial Group). The main advantage over the GRAT is that there is no risk that the entire value of the business interest will be transferred back into the taxpayer's estate. Even if the taxpayer dies prematurely, only the outstanding balance of the note (plus any interest already paid) will be included in the taxpayer's estate (Brown). To illustrate, say a taxpayer sells a $1 million business interest (40% stake) for only $600,000 (assuming a 40% discount). Upon the sale, he would have effectively removed a $1 million interest in return for a $600,000 note (assuming that no principal payments had been made during the trust term), thereby eliminating $400,000 from his estate.

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[5] Because the irrevocable trust is intentionally drafted to be a grantor trust, the sale to the trust is treated as a non-taxable event (Rev. Rul. 85-13)

[6] Long-term AFR applies (November 2010 rate is 3.35%) (Evans)

Moreover, if the IDIT generates income on the business interest that exceeds the interest payments owed to the taxpayer, the additional earnings can be used to fund a life insurance policy, thereby turning the IDIT into an ILIT as well (Lincoln Financial Group).

Private Annuity

A private annuity has similar features to the GRAT and IDIT. Typically, a taxpayer will sell a business interest to his child in exchange for a lifetime annuity payment, which is determined by the IRC section 7520 rate used for the GRAT (120% of the midterm AFR) and the taxpayer's life expectancy based on IRS actuarial tables (Giarmarco). As with the GRAT and IDIT, future appreciation of the interest that occurs after the exchange as well as the earnings on the interest in excess of the annuity payments can pass on to the child free of any estate of gift tax consequences. Valuation discounts are also available to reduce the size of the annuity (Bannon).

One difference is that a private annuity sale is treated as taxable, and the taxpayer must recognize the entire gain or loss on the sale of the business interest ("Internal Revenue Bulletin"). As a result, each annuity payment the taxpayer subsequently receives from the child will consist of a partial return on the taxpayer's basis in the interest as well as interest income (subject to income tax) (Giarmarco).

If the taxpayer dies prematurely, the annuity payments are terminated and his unrecovered basis in the interest will be excluded from his estate (Giarmarco). Consequently, if the taxpayer does not expect to reach his actuarial determined life expectancy, he may want to consider using a private annuity due to the possibility of a huge windfall. The IRS, however, generally requires some type of premium (say 10%) to cover the fact that the taxpayer may die prematurely and trigger substantial estate and gift tax savings (Bannon).

The biggest downside to the private annuity is that if the taxpayer lives significantly beyond his life expectancy, the trust could end up paying far more for the business interest than it is worth, which would drive up the value of the taxpayer's estate (Lincoln Financial Group). Unless a taxpayer has a known illness that is likely to reduce his life expectancy, this is probably not a technique most taxpayers will embrace.

Irrevocable Life Insurance Trust (ILIT)

Unlike the GRAT, IDIT, or private annuity, which involve gifting or selling business interests out of one's estate, the ILIT is created for the sole purpose of owning an insurance policy on the taxpayer's life. Essentially, a taxpayer will make a gift to an irrevocable trust (set up for benefit of his heirs), whereby the trustee (in charge of the irrevocable trust) will use the funds to secure a life insurance policy on the taxpayer's life (Alper). When the taxpayer dies, the life insurance proceeds are paid to the trust free of any income or estate taxes (Lincoln Financial Group). Consequently, the trust can then distribute the tax-free proceeds to the beneficiaries (presumably the taxpayer's heirs) so that they can pay a portion of the taxpayer's estate taxes (Bannon).

In the event that the taxpayer already owns a life insurance policy, he can transfer the ownership of the policy to an ILIT. However, he must live at least three years after date of the transfer in order to remove the policy from his estate. If he dies before this three-year time frame, the insurance policy funds will be transferred back into his estate (IRC section 2035).

The main downside to the ILIT is there is a limit on how much insurance can be obtained, and the taxpayer must make gifts to the trust (often on an annual basis) to fund the premium payments, which could trigger substantial gift taxes, particularly if the trust has secured a multi-million dollar insurance policy on the taxpayer's life (Bannon). As discussed in the IDIT section,

it is possible that the excess earnings on the business interest transferred into the IDIT (in excess of the amount payable on the note) could help fund a life insurance policy without triggering additional gift taxes (Bannon).

Optimal Estate Planning Strategy

Because a taxpayer will not benefit from a GRAT if he dies prematurely and could be worse off with a private annuity if he lives too long, establishing an IDIT and then using the excess cash flows from the trust to fund a life insurance policy seems like a safer, more viable alternative. If properly structured, the trust (acting as both an IDIT and ILIT) could serve as a mechanism for reducing (via valuation discounts) McCourt's taxable estate and providing McCourt's sons with enough proceeds upon their father's death to pay off the high estate tax under IRC section 6166.

Assuming that the Dodgers franchise is organized as an LLC, the first step in implementing this strategy would be to have McCourt create an IDIT with his sons as the beneficiaries. Since the initial seed payment required to establish the trust is rather insignificant (only 10% of the value of the property being sold), it will be disregarded for purposes of this paper ("IDIT"). Once the trust has been set up, McCourt can sell a partial interest in his franchise to the trust to take advantage of the available valuation discounts.

I will make the assumption that he sells a 40% stake in the Dodgers.[7] Given that the franchise is worth an estimated $400 million (after debt), a 40% interest would be valued at $160 million. Due to the fact that a buyer is not going to be willing to pay a pro-rata price for a minority interest in the team, the value of the 40% interest must be discounted. Based on comparable tax cases, a discount of 40% for "lack of control" and "lack of marketability" seems

[7] Holding on to a 60% stake of the company will provide him more than enough income given that the team generates an estimated $11.1 million per year (does not include his $5 million salary)

appropriate.[8] After applying the discount, McCourt would be selling the $160 million interest to the IDIT for only $96 million ($160 million – 40% discount).

In exchange for the discounted 40% business interest, McCourt will receive an interest only promissory note from the trust in the face amount of $96 million. The annual interest payable to McCourt would be $3,216,000, calculated by multiplying $96 million by 3.35% (November 2010 long-term applicable federal rate) (Evans). Given that the trust will generate an annual pre-tax cash flow of approximately $4.44 million on its 40% business interest in the team (determined by multiplying the team's projected pre-tax cash flow of $11.1 million in exhibit 1 by 40%), it can afford to pay the interest payments on the note and use the annual excess $1,224,000 ($4,440,000 - $3,216,000) to fund a life insurance policy on McCourt's life.

According to Mel Bannon, a wealth management advisor with Lincoln National Life Insurance Company, the maximum amount of life insurance that can be obtained is about $65 million, and a healthy male in his mid-fifties would have to pay an annual premium of approximately $1 million to secure such a large policy. The IDIT, which can be structured to also meet the requirements of an ILIT, can make these annual premium payments and still retain $224,000 per year ($1,224,000 - $1,000,000). This excess cash flow can be left in the trust to grow estate tax free, or the trustee can distribute these funs to the sons as beneficiaries of the trust. Since an IDIT is intentionally structured as a grantor trust, all the income generated by the trust's 40% business interest will be taxed directly to McCourt (IRC section 671), which has the added benefit of lowering the size of McCourt's estate by the amount of taxes he pays on behalf of the trust.

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[8] Miller v. Commissioner, Pierre v. Commissioner, and Keller v. U.S reported uncontested valuation discounts of 35%, 37.5%, and 47.5%, respectively (see works cited for full citations).

Adjusted Federal Estate Tax Liability and Installment Plan (IRC section 6166)

Upon McCourt's death, his estate will include the 60% interest in the Dodgers that he retained, plus the outstanding balance of the promissory note owed to McCourt by the trust ($96 million assuming no principal payments were made prior to his death). Since this paper assumes that these are the only assets in McCourt's estate, his gross adjusted estate would be $336 million, resulting in an estate tax liability of $152.5 million (see exhibit 7).

Exhibit 7

Team value (gross estate)	$800 mil
Less debt	($400 mil)
Gross adjusted estate	**$400 mil**
40% interest sold to IDIT	($160 mil)
Gross adjusted estate (60% interest retained)	$240 mil
Add back outstanding balance on promissory note	$96 mil
Gross adjusted estate	**$336 mil**
Estate tax rate	45%
Federal estate tax liability	**$151.2 mil**

Although the initial valuation discount has substantially reduced McCourt's estate by $64 million and removed any appreciation of the 40% interest sold to the trust as well, the tax liability is still significant. However, the life insurance proceeds will reduce that liability by $65 million, and the remaining $87.5 million must then be satisfied under the installment rules of the IRC section 6166. Under IRC section 6166, interest only is payable for the first four years after the return due date (9 months after McCourt's date of death). Over the following ten years, equal annual installments of principal plus interest must be paid. Assuming the current section 6166 interest rate of 1.54% (45% of the interest rate charged on the underpayment of taxes) and a remaining estate tax liability of $87.5 million, the sons will be subject to an annual payment of approximately $9,446,639.[9]

[9]The loan calculator on bankrate.com calculated the monthly payment of $787,219.9, which I multiplied by 12.

Since the franchise's annual deductions for stadium depreciation and amortization of intangible assets (i.e. player contracts) will shelter the team from paying income taxes for up to 15 years after McCourt's death (IRC section 197), upon inheriting the team the sons will be able to use the Dodgers' entire adjusted pre-tax cash flow of $14.1 million (see exhibit 2) to pay off the estate tax. Therefore, the sons will have more than enough funds to cover the interest only payments of $1,347,500 for the first four years (calculated by multiplying section 6166 interest rate by $87.5 million) and the equal annual installment of $9,446,639 over the following ten years.

Conclusion:

Although the federal estate tax can present a major hurdle for family-run businesses to be kept in the family, my paper demonstrates that it is possible to reduce this burdensome tax through a combination of estate planning techniques. At the same time, these strategies may require an owner to give up control over a portion of his business and could involve other substantial costs (i.e. legal fees). These non-tax considerations should be taken into account before engaging in complex estate planning. However, given that McCourt has expressed a desire to pass the ownership of his business to his children, he will probably have to implement one or more of the estate planning options discussed in this paper to achieve this objective in the high estate tax environment we may again be facing in 2011.

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