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Vanishing stocks

A March study of publicly listed stocks available to American investors revealed a shocking shrinkage. The total value of stocks has grown, but the number of companies listing their stocks on the exchanges is half what it was 20 years ago. This issue of Trusted Insights *explores some of the reasons that may be behind this trend.*

Next, an example of aggressive estate tax planning that didn't pan out.

Finally, although there has been little visible progress on the tax reform front, the issue is still in the news. We're staying on top of it—if it should happen, new tax legislation could have important implications for us all.

Questions or suggestions for Trusted Insights*? Please direct them to me.*

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The incredible shrinking stock market

Equity investors have welcomed the robust growth in stock prices this year, as the stock market indices have repeatedly reached new highs. There has been a burst of optimism, and the economy has continued to grow, if slowly. But another factor may well be a shortage of investment opportunities. The number of stocks listed on the exchanges has been in steep decline for many years.

A study released by Credit Suisse last March documents the phenomenon in detail. The number of listed stocks on U.S. exchanges peaked in 1996 at 7,322. Today there are roughly half as many, 3,671. And that number is 20% lower than the number of listed stocks in 1976!

From 1976 to 1996, Gross Domestic Product (GDP) in the U.S. grew by about 90%, according to the study. During that time frame, the number of listed stocks grew by roughly 50%. In the next 20 years, from 1997 though 2016, GDP rose by another 60%, but the number of listed stocks *fell* by about half.

Many trends in play

Why the reduction? It's not that there are fewer companies being formed. The number of firms eligible to be listed has grown slightly, from 550,000 in 1996 to 590,000 today. Instead, it seems that the benefits of being a listed company have declined, while the costs have increased. The benefits include:

- the ability to raise funds through the public market;
- being able to use shares as currency, to compensate employees or engage in mergers and acquisitions;
- creating liquidity for shareholders;
- establishing trust among investors by meeting the legal standards and disclosures required to be a publicly traded company.

However, that last point suggests how the costs have grown:

- expenses for mandatory disclosures have risen, especially in the wake of the Sarbanes-Oxley Act of 2002;
- mandatory disclosures may create competitive disadvantages, alerting competitors to a firm's plans and resources;
- quarterly earnings reports create a

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THE CHANGING UNIVERSE OF PUBLICLY TRADED STOCKS

Listed companies today are larger, older and more profitable than they were 20 years ago.

	1976	1996	2016
Number of listed companies	4,796	7,322	3,671
Market capitalization ($billions)	$2,975	$12,322	$25,303
GDP ($billions)	$6,325	$11,769	$18,565
Ratio of market cap to GDP	47.0%	104.7%	136.3%
NYSE annual share volume (millions)	5,360	104,636	316,495
Average age of a listed company	10.9	12.2	18.4
Average size of a listed company ($millions)	$620	$1,683	$6,893
Mutual fund assets under management ($billions)	$40	$1,725	$8,725

Source: Credit Suisse, *The Incredible Shrinking Universe of Stocks* (March 22, 2017)

Stock market . . . continued

short-term focus;

- pressure from activist investors.

The bottom line is that publicly traded companies now tend to be older and larger than in the past.

Alternatives

In 1976, 50% of stocks were owned directly by individuals. Now, only 21% are, as individual investors have turned to mutual funds and exchange-traded funds (ETFs) to complete their portfolios. The majority of listed stocks today are owned by institutions, up from 20% 40 years ago.

ETFs began to gain in popularity about the time that the number of listed stocks began to fall. From assets of just $2 billion in 1996, ETFs now have $1.8 trillion under management. ETFs give investors an alternative to buying and owning stocks directly, and they can be used to build relatively lower-cost diversified portfolios.

Looking ahead

The authors of the study do not expect changes in these trends in the near term. Alternative investments, such has hedge funds, buyout funds, and venture capital funds have given investors more choices, but those vehicles have not generally outperformed the market. The maturity of the listed companies has contributed to information efficiency about their prospects, compared to the uncertainty about the success of younger companies. The size and age of these companies make it more likely that they will be paying out cash to shareholders as dividends.

Failure of a deathbed FLP

Jeffrey Powell had a power of attorney for his mother, Nancy. On August 6, 2008, he created NHP Enterprises LP, a limited partnership. Jeffrey was the general partner. On August 7, 2008, two doctors at Marin General Hospital expressed their opinion that Nancy was incapacitated and could no longer act on her own. On August 8, under the power of attorney, Jeffrey transferred $10,000,752 from Nancy's living trust to the partnership in exchange for a 99% limited partnership interest. Next on August 8, again under the power of attorney, Jeffrey transferred the 99% partnership interest to a charitable annuity lead trust. An annuity was to be paid to the Nancy H. Powell Foundation for the rest of her life, with the balance to be divided between two trusts for Jeffrey and his brother at her death. Nancy died on August 15, 2008, one week after these transactions.

A gift tax return was filed for Nancy for 2008, reporting the transfer to the charity. The 99% partnership interest was valued at some $7.5 million, after applying a 25% discount for lack of control and lack of marketability. Nancy's actuarial life expectancy was used to value the annuity, which brought the taxable value of the remainder interest down to $1.6 million.

The $10 million used to acquire the limited partnership interest was not included on Nancy's estate tax return.

A notice of deficiency

The IRS had a multi-pronged attack on this arrangement. On the gift to the charity, the 99% partnership interest was valued by the IRS at $8.5 million. More importantly, the IRS did not use the actuarial tables to value the income interest, because Nancy already was terminally ill—in fact, she died just a week later. That change increased the value of the remainder interest to $8.3 million, generating a gift tax obligation of $2.9 million.

The Service also included in Nancy's estate the entire amount transferred to the partnership in exchange for the limited partnership interest, offering alternative theories for estate inclusion. Either she retained the right to the income from the property, under IRC §2036(a), or she had the power to change the enjoyment of the property or to alter, amend, revoke, or terminate it under IRC §2038(a). The fair market value of the limited partnership interest was determined without regard to any rights or restrictions identified in IRS §2703(a).

The total deficiency came to $12.9 million, because the amount of gift tax payable was added back to the estate under IRC §2035(b), which requires the estate inclusion of gift taxes paid within three years of death.

The structure falls apart

The IRS also argued that the bona fide sale exception found in IRC §2036(a)(2) does not apply, given that the estate immediately claimed a discount on the value of the 99% limited partnership interest. Obviously, Nancy did not receive adequate and fair compensation in the exchange.

Before the Tax Court, the estate conceded the IRS' arguments under §2036. It was left to claim that through the transfer to the charitable lead trust, Nancy no longer possessed those powers at her death.

That approach has two important flaws, according to the Tax Court. Although the three-year rule of estate inclusion for gifts in contemplation of death does not apply as broadly as it once did, IRC §2035(a)(2) continues to apply the rule to any transfers covered by IRC §§2036, 2037, 2038, or 2042.

More importantly, the power of attorney did not give Jeffrey an unlimited power to make gifts of Nancy's property. Gifts were limited to a specific class of beneficiaries, and were further limited to the amount of the federal gift tax annual exclusion. Therefore, the transfer to the charitable lead trust was void.

The Tax Court also discussed the effect that IRC §2043 has on this situation, apparently the first time that the issue has been squarely before the Court. That Code Section prevents the possibility of double taxation, as it acts as a brake on §2036. "The illogic of including in the value of a decedent's gross estate both the assets transferred to a family limited partnership and the partnership interest received in return seems to have been widely recognized, but the precise legal grounds that prevent such illogical 'double taxation' have gone unarticulated," the Court stated.

It is IRC §2043(a) that resolves the conflict, as it works in tandem with the §2036(a)(2) test for adequate consideration. "[W]e conclude that, when section 2036(a) (either alone or in conjunction with section 2035(a)) requires the inclusion in the value of a decedent's gross estate of the value of assets transferred to a family limited partnership in exchange for an interest in that partnership, the amount of the required inclusion must be reduced under section 2043(a) by the value of the partnership interest received by the decedent-transferor."

The only good news for the estate is that, because the Court ruled that there was no completed gift, there was no federal gift tax due [*Powell, Estate of Nancy H. et al. v. Commissioner,* 148 T.C. No. 18].

The decision was not unanimous

Tax Court Judge Lauber concurred in the result, but believed that the family limited partnership itself was invalid from its creation. He also rejected the Court's §2043 analysis as a "solution in search of a problem." He worried that this reading of §2043 might open a Pandora's box of new and overly aggressive estate planning strategies. Six of the Tax Court judges joined the concurrence.

Briefly noted

Is Congress getting serious on taxes?

Given the failure of Republicans in Congress to enact health insurance reform, many observers have suggested that tax legislation has become critical. An important step was taken on September 27 with the release of a "framework" for such legislation. Personal tax rates of 12%, 25%, and 35% were agreed to, and the door was left open for a fourth tax rate for the highest income segment. The target for the corporate rate was reset to 20%, and pass-though entities would be taxed at 25%.

The tax cuts would be paid for in part by eliminating most deductions, including the deduction for state and local taxes. "Tax incentives" would be left in place for mortgage interest and charitable gifts.

No additional light was shed on transfer taxes. The proposal calls for eliminating the "death tax" and the generation-skipping transfer tax. It is silent on the gift tax. Similarly, there is no hint about the possibility of imposing a tax on unrealized capital gains at death, or, in the alternative, reestablishment of carryover basis.

Passage of a new tax law by the end of the year seems unlikely, but something might be enacted early in the new year.

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