

Letter from VMI's Managing Director

Dear Friends & Clients:

Thanks to our valued clients and appreciated referral sources, Value Management Inc. continues to grow. Our recent move to a larger space in Jamison, PA was necessary to accommodate our growing professional staff. Your confidence in us is appreciated and we will continue to focus on ways to better serve you.

Our thriving business valuation practice, which includes valuations performed for a wide variety of purposes (e.g. ESOPs, estate and gift, income tax, financial reporting, shareholder matters, litigation support, etc.), is complemented by our rapidly expanding merger and acquisition service segment.

In each of the appraisals we perform (over 250 annually), our goal is to deliver independent, thoroughly supportable, timely and credible valuations. We are committed to providing personalized attention to every engagement whether it involves a small "mom & pop" operation or a multi-billion, multi-national firm.

Thanks again for your support and we look forward to serving your valuation and transaction needs!

Sincerely,
Ed Wilusz, ASA, CFA
Managing Director

Finally, a Tax Court Considers a 'Good Facts' Family Limited Partnership

Estate of Mirowski v. Comm'r, T.C. Memo. 2008-74 (March 26, 2008)

After a recent string of "bad facts" cases dealing with family limited partnerships (FLPs) and limited liability companies (LLCs), the U.S. Tax Court delivered some relief to taxpayers with this new case. Mirowski also provides a potential "roadmap" for good planning, funding, and presenting an FLP or similar entity, such as a limited liability company, should it meet an IRS challenge under IRC §2036(a).

Long-term planning, sudden death

Mrs. Mirowski's husband, a physician, helped develop a patented medical device in the 1960s, which became enormously profitable after his death in 1990. Continuing a long history of family and charitable giving, Mrs. Mirowski retained a majority (51.09%) interest in the patent and licensing agreements, but gifted the remaining interest into three irrevocable trusts for each of her daughters.

In August 2001, and with the assistance of her financial advisors, she executed the Mirowski Family Ventures (MFV), a limited liability company, and funded it within a week with more than \$60 million in assets, including the 52% interest in medical patents. In early September, she gave each of her daughters' trusts a 16% member interest in MFV, for a total of 48%. The MFV operating agreements designated Mrs. Mirowski as general manager, but a sale or other transfer of the company required approval of all members.

Mrs. Mirowski retained substantial personal assets (over \$7.5 million). Four days after funding MFV, Mrs. Mirowski died suddenly from complications of her diabetes.

Family management is key

Mrs. Mirowski's estate paid over \$14.1 million in
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Lack of Independent Business Valuation Affects Viability of Fraud Claims

Lusins v. Cohen, 2008 WL 662717 (New York) (March 13, 2008)

Clients who opt to save money in the short-term by foregoing a formal business valuation in connection with buy-sell agreements could eventually add considerable cost to any attendant dispute, including claims against the business' attorneys.

Parties initially agree on minimum value

At the time of his death, the decedent was a partner in multiple medical business entities with another physician. The partners had a buy-sell agreement providing that should one of them die, the succeeding partner would be entitled to purchase the deceased's partner's share for no less than \$500,000. After receiving information concerning the business' financial condition from their attorney, their CPA, and the succeeding partner, as well as advice from the estate's attorney, the deceased's daughter, acting as executor of the estate, agreed to sell her father's share for \$500,000.

Shortly thereafter, a family friend and CPA informed the widow that the value of her husband's interest in the entities "far exceeded" \$500,000, and that their financial condition had been "misrepresented." She subsequently sued her husband's former partner, the entities' attorney and their CPA for fraud, negligent representation, and breach of fiduciary duty, and requested an accounting. The trial court dismissed all of the plaintiff's claims except for the accounting request, and she appealed.

Appraisal could have uncovered value

At trial, the estate's attorney testified that the defendants had provided all requested financial and legal documents, and that he, in turn, had sought advice from decedent's CPA, who was "intimately familiar" with the business entities and could assist in their valuation. After reviewing the documents, the CPA believed that "the estate would not be able to establish a valuation greater than \$500,000." It was also significant that the CPA did not convey any information that conflicted with the defendants'.

More importantly, before the estate accepted the \$500,000 payment, the widow could have compelled an independent valuation of the entities, discovering their "true nature" and underlying condition. But because she declined to do so, the widow could not

estate taxes, but on audit and pursuant to §2036, the IRS determined that the estate owed an additional \$14.2 million in taxes, based on the inclusion of all assets transferred to MFV. The IRS tried to compare MFV to prior "bad facts" cases in which the Tax Court rejected an FLP or similar entity based on improper or belated funding, failure to observe partnership structure and management procedures, and other "badges" of non-business purpose. In these cases, the FLP often had little use beyond an estate planning (and tax avoidance) device.

By contrast, the estate distinguished this case by its comparatively "good facts." For instance, even though Mrs. Mirowski died within days of funding MFV, her death was entirely unexpected. Although she realized that forming MFV could result in potential tax benefits, her primary motivations were: (1) Joint management of the family's assets by her daughters and eventually her grandchildren; (2) pooling the assets to allow for investment opportunities that would not be available if she made separate gifts to each of her daughters or their trusts; (3) providing additional protection from potential creditors for the interests in the family's assets; and (4) providing for each of her daughters and ultimately her grandchildren on an equal basis.

The Tax Court agreed with the estate, finding that MFV had "real and significant nontax business purposes" that met the §2036(a) criteria to apply the "bona fide sale" exception to the transfers. In fact, based on the record, the mother's wish for her daughters to remain "closely knit and be jointly involved" in managing the family assets was the most significant nontax purpose and "standing alone," the court held, was sufficient to qualify for the §2036(a) exception.

The IRS claimed that Mrs. Mirowski had failed to retain sufficient assets outside of MFV to support her own expenses as well as her daughters' substantial gift tax liability.

But the court found that she could have paid this expense from her retention of over \$7.5 million in assets or from the anticipated MFV distributions. At no time before her death, the court said, did the members of MFV have any agreement, express or implied, to fund the liability with MFV assets.

Finally, even though Mrs. Mirowski was the general manager of MFV, her powers and discretion were subject to the operating agreement—including its requirement of other members' approval for major transactions. The court found no agreement, express or implied, that by her position she retained a right or interest into the respective 16% interests in MFV that she gave to her daughters' trusts.

have justifiably relied on any alleged deception by the defendants, and the appellate court upheld the dismissal of the claims against them.

*If you are interested in having one of our analysts speak to your firm or give a presentation at a conference, please contact Susan Wilusz, at: (215) 343-0500
smw@valuemanagementinc.com*

Fair Value—More Disclosure, More Litigation, More Risk?

Fair value is perceived as more susceptible to fraud and manipulations because judgment is so central to its conclusions. New information enters the market every day, affecting fair value and impacting far more than just the final numbers on the balance sheets. Companies are reclassifying assets and liabilities, recognizing longer holding periods regarding intransigent debt, and reassessing impairment issues more frequently. Even taking assets off the books doesn't remove the obligation for corporate directors and managers to disclose the fair value of the related risks and rewards.

But even if corporate officers, auditors, and financial analysts all follow the rules, in the short term, at least, the situation is going to get more difficult, possibly resulting in more litigation. Although during the past couple of years, Sarbanes-Oxley may have helped bring about a brief decline in securities litigation, so did persistent market stability during the same time. But the current market volatility, brought about in part by the effective date of FAS 157 in early 2008 and the introduction of fair value judgments, could prompt a securities litigation boon, because plaintiffs will have strong economic incentives to claim that accounting issues are responsible for their losses.

Preparers will be at the center

The U.S. Supreme Court's recent decision in *Tellabs, Inc. v. Makor Issues and Rights*, (2007) has turned up the pressure by essentially telling the lower courts to make an early finding in securities lawsuits whether corporate directors exercised good judgment in good faith. If the courts and the Securities Exchange Commission permit preparers to be liable for good faith judgments that turn out to be wrong, the movement toward adoption of fair value accounting could stall. Auditors, financial officers, and others will find it increasingly difficult to make complex judgment calls when it could expose the company, and their careers, to legal liability.

To mitigate the litigation threat, the SEC could move toward adopting a rigorous professional judgment standard. This would help codify the steps that auditors, management, and boards could take to defend themselves against litigation, claims of fraud and poor judgment. In the meantime, to decrease the risk of liability, corporate managers are well-advised to seek fair value for financial reporting expertise from independent valuation specialists.

IRS Proposes Writing Kohler Out of the Law

Last March the Internal Revenue Service announced its decision not to acquiesce in the Tax Court's ruling in *Kohler v. Commissioner*. (See the Action on Decision published in the *Internal Revenue Bulletin*, 2008-9, March 3, 2008). A brief footnote elaborated:

Nonacquiescence relating to whether I.R.C. section 2032 allows a discount for transfer restrictions and a purchase option imposed on closely-held corporate stock pursuant to a post-death tax-free reorganization in determining the fair market value of the decedent's stock on the alternate valuation date.

Section 2032 generally permits an estate to elect an alternate valuation date, six months after the date of a decedent's death. If the overall value of the estate has decreased during that time, the estate can reduce its tax burden. The IRS expanded on its decision in April, when it published new rules in the Federal Register that would permit estates to elect the alternate valuation date (per §2032(a) and Form 706) only when market conditions and not "other post death events" have reduced the gross value of the estate. (For the complete proposed regulations, see <http://edocket.access.gpo.gov/2008/pdf/E8-9025.pdf>.)

Congress enacted the predecessor to Section 2032 after the Depression, when market values decreased so materially from the date of death to the date of distribution that at times, "many estates were almost obliterated by the necessity of paying a tax," the IRS says. Since then, two cases have interpreted the provision differently. In 1972, a federal district court in California excluded any reduction in an estate's value that resulted from the trustee's "voluntary acts." But in 2006, the *Kohler* decision permitted the Tax Court to consider a post-death reorganization of the company that resulted in discounts (due to transfer restrictions) on the value of the estate's stock holdings. To resolve the apparent conflict, the IRS now seeks to amend Section 2032(f) so that only "market conditions" will make the alternate valuation date available:

The term market conditions is defined as events outside of the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued. Changes in value due to mere lapse of time or to other post-death

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events other than market conditions will be ignored in determining the value of decedent's gross estate under the alternate valuation method.

Would the Kohler outcome be any different?

The Tax Court found several legitimate reasons for the Kohler Company's reorganization, including removing outside shareholders and keeping the longstanding private company within family control. The estate—which owned 12.5% of the voting stock, “could not have blocked or approved the reorganization on its own,” the court said. Nor did it have the power to change management, the board of directors, or the company's articles of incorporation. While the Tax Court did not specifically find that

the reorganization was a corporate event—if it was beyond the estate's control, then would the market value of the estate's shares necessarily reflect the resulting transfer restrictions, no matter the valuation date? For example, the date of death would reflect the expectation that the reorganization would take place, while the alternate valuation date, six months later, would reflect the actual restructuring.

Until this matter is resolved definitively, however, attorneys can expect continued debate—and litigation—regarding what comprises market conditions and how these forces affect valuation during the alternate valuation period.

Please note our new contact information:

2370 York Rd. E2
Jamison, PA 18929

(215) 343-0500 phone | (215) 343-0501 fax

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