

Fall, 2003

COURT CASE UPDATES

Three cases involving business valuation issues have received considerable attention in the estate tax/planning community. Two of the cases involve tax issues and the third addresses the selection of appropriate discounts for a limited liability partnership. This edition reviews these cases. The actual court case links are listed below.

Estate of Albert Strangi v. CIR, T.C. Memo 2003-145 and the Section 2036 Minefield

The Fifth Circuit Tax Court considered whether IRC Section 2036 applied to the assets transferred to a Family Limited Partnership.

The decedent transferred cash, marketable securities, and other assets having aggregate value of \$9.9 million to the Strangi Family Limited Partnership and received a 99 percent limited partnership interest in the FLP and a 47.6 percent interest in Stranco, Inc., the corporate general partner. The remaining interests in the FLP were held by members of the decedent's family, including his attorney-in-fact (his son-in-law). The IRS contested the valuation of the decedent's limited partnership units and his interest in Stranco, Inc.

On remand, the Tax Court first considered whether the value of the assets transferred to the FLP should be included in the decedent's gross estate under Section 2036 (a) (1). This section permits inclusion in the gross estate of the value of the transferred assets when the "decedent retain(s), by express or implied agreement, possession, enjoyment, or right to the income." The Court found that the documents indicated an expressed agreement to retain the right to income from the transferred assets, which mandated inclusion of the value of the transferred assets under sec.2036(a)(1).

The Tax Court considered whether the evidence also supported an implied agreement to retain a possession or enjoyment of transferred assets. The Court considered a "non-exclusive" list of factors. Crucial to the courts decision were the facts that:

- # Decedent died 2 months after the FLP was created;
- # Decedent transferred substantially all his assets to the FLP, including his residence and almost all of his liquid assets;
- # Decedent's attorney-in-fact (his son-in-law) controlled the FLP;
- # FLP assets were used for the decedent personal expenses; and
- # No other partner had any meaningful economic interest in the FLP.

The Tax Court concluded that the value of the transferred assets (undiscounted) should be included in the value of the decedent's gross estate under sec. 2036(a)(1) and (a)(2).

IRS attacks against FLPs have been successful where acts or omissions by a family cast doubt on the legitimacy of the FLP. Although it is unlikely that any single factor will be decisive, a pattern of activity which indicates that the family has failed to treat the FLP as a separate legal entity may prove fatal. When creating and operating an FLP, the following guidelines (source: Estate Planning, July 2003, "How Family Partnerships Can Navigate the Section 2036 Minefield") will increase the chance of success against a possible IRS challenge:

1. Organize and fund the family limited partnership and make gifts of FLP interest before death is imminent. Deathbed transfers to an FLP will be scrutinized closely by the IRS.
2. Fund the FLP with assets requiring ongoing management, such as income producing real estate or

interests in closely held business, rather than just passive investment assets. If only passive investment assets are available, document the reasons for the existence of the FLP, such as to provide creditor protection, to centralize investment authority, or to take advantage of investment opportunities not available on a smaller scale.

3. Do not transfer personal use assets to the FLP. If personal assets are transferred, discontinue any personal use after the transfer of such assets to the FLP. A partner should pay the FLP fair market rent for use of any FLP assets.

4. Do not transfer substantially all of the taxpayers assets to the FLP; instead, he or she should retain sufficient assets to provide support outside the FLP. If the taxpayer's support is dependent on the FLP distributions, the IRS may argue that the taxpayer retained an income interest in the assets contributed.

5. Have more than one partner make substantial contributions to the FLP. A pooling of interest will help establish the FLP as a true joint venture or enterprise, not merely a testamentary vehicle.

6. Transfer and title all FLP assets properly in the name of the FLP. If real estate is contributed, the deed should be signed and recorded. Assign any leases to the FLP and pay all rental income directly to the FLP. If certificated securities are contributed, each certificate should be assigned, delivered to the transfer agent, and retitled in the name of the FLP. All dividends should be paid directly to the FLP. If a closely held business or investment interest is contributed, comply with any applicable transfer restrictions.

7. Do not transfer FLP interests until all FLP assets have been properly transferred to the FLP.

8. Establish a separate bank or brokerage account for the FLP and make all FLP contributions to, and distributions from, the account.

9. If possible, have more than one general partner. If there is only one general partner and it is an entity, the entity should be controlled by more than one individual.

10. Require the general partner to (1) prepare and distribute annual financial statements, (2) calculate capital accounts annually, and (3) adjust percentages of ownership for distributions to, or capital contributions by, partners.

11. Make distributions of income pro rata to all partners, unless the partnership agreement specifically provides for non-pro rata distributions.

12. When drafting the partnership agreement, do not waive the general partner's fiduciary duties to the partnership or to the other partners.

13. Do not use FLP funds to pay personal expenses of the partners.

14. If possible, avoid loans to the partners. Any loan data should be evidenced in writing and should provide for interest at the applicable federal rate.

15. Make sure that any compensation paid to a partner by the FLP is reasonable.

16. Make all federal estate filings for the FLP in a timely manner.

17. If required, file a gift tax return in a timely manner reporting the gift of an FLP interest, and attach a copy of a qualified appraisal of the gifted interest.

18. Do not be overly aggressive with valuation discounts.

Hackl v. Commissioner, U.S. Court of Appeals For the 7th Circuit, July 11, 2003.

In Hackl (Hackl v. Commissioner, 118 T.C. No. 14 (U.S. Tax Ct. March 17, 2002)), the court ruled that gifts of limited liability company interests were gifts of future interests and did not qualify for the annual gift tax

exclusion. In *Hackl II*, the taxpayer's argument was that the gift tax does not apply to a transfer if the donors give up all of their legal rights. They also argued that their position reflected the meaning of "future interests" in the statute and the Tax Court's reliance on materials outside the statute (such as Treasury regulations and case law) was wrong. In what the 7th Circuit called "hedging their bet", the Hackls also argued that the Treasury regulations support the conclusion that giving up all legal rights makes their gift a present interest. The 7th Circuit noted that even though the voting shares that the Hackls gave away have the same legal rights as those they retained, the restrictions on transferability of the shares for the LLC operating agreement meant that they were essentially without immediate value to the donees.

The Hackls argued that their LLC was the same as any other LLC and the restrictions on share transfers are common in closely held companies. The 7th Circuit said, "while this may be true, the fact that other companies operate this way does not mean that shares in such companies should automatically be considered present interests for purposes of the gift tax exclusion."

The 7th Court concluded "that the onus is on the taxpayers to show that their transfers qualify for the gift tax exclusion, a burden that the Hackls have not met."

Charles McCord, Jr. v. CIR, 120 T.C.No.13 (May 14, 2003)

The Tax Court considered several issues regarding the valuation of a limited liability partnership (LLP). The LLP was formed in 1995. The taxpayers and their children contributed primarily stocks, bonds, real estate, oil and gas interests and other closely held business interests to the partnership. The McCords contributed most of the assets and received all the Class A partnership units, and 82 percent of the limited partnership units. The four children were general partners, each owning a 0.267 percent Class B general partner interest. Additionally, the partnership formed by their sons received a 16.59 percent limited partnership interest. The parents owned the remainder of limited partnership interests.

The issues in this gift tax matter were (1) the extent of the rights assigned by the McCords and (2) the fair market value of the gifts. The IRS first argued that the McCords valued the wrong asset.

Where the McCords valued assignee interest in the transferred Class B units, the IRS argued that the McCords actually transferred limited partnership units rather than assignee interest. The Court found that the McCords transferred assignee interest. It found that the McCords did not intend to transfer all their rights, but only to transfer assignee interests that consisted of economic rights of the partnership interest.

The Court then turned to the parties disagreement over the valuation of the assignee's interest. The LLP had a net asset value of \$17,673,760. The LLP's portfolio consisted of equities (20.6 percent), bonds (45.5 percent, 75 percent of which were issued by the state of Illinois), real estate interest (29.4 percent), real estate (3.3 percent) and oil and gas interests (1.1 percent).

The parties agreed to a 40 percent discount on the real estate (for lack of control) and 33.5 percent discount on the oil and gas interests. However, they disagreed over the calculation of the discount on the remaining asset classes.

Each asset category was separately considered. The court examined the merits of each appraiser's selection of how the minority discount should be determined for the asset category. The decision discusses in detail its selection of the appropriate discount. It then weighted the results of the minority interest discounts determined by the asset class. It concluded a 15.18 percent minority interest discount should be applied to the underlying assets in the LLP.

The Court next considered the appropriate discount for lack of marketability to be applied to the LLP. The taxpayer's expert primarily relied upon restricted stock studies to support a 35 percent discount. He analyzed the studies in relation to the LLP by revenue, income and asset value. He further testified that he considered the pre-IPO studies and they also supported his conclusion.

The IRS expert opined that a 7 percent marketability discount was appropriate. This was based on his own private placement study as well as two other studies. The IRS expert rejected the use of the pre-IPO studies as a method for calculating a discount.

He reasoned that low pre-IPO prices may be attributable in part to compensate the purchaser, who is frequently an insider and an employee of the issuer.

The taxpayer's expert did not offer a rebuttal to these criticisms, and, as such, the Tax Court found the pre-IPO studies lacking.

It rejected the taxpayer's expert's opinion to the extent that it relied upon the pre-IPO studies.

The Tax Court then considered the McCords' expert analysis based on the restricted stock studies. It found that he consistently considered a 1 percent interest in the LLP when the size of the gifted interest was 41 percent for each donor. The Court relied on the IRS expert's private placement analysis. It rejected his low discount (7.23 percent) but found that a 20.36 percent discount was applicable (rounded to 20 percent).

The Court revalued the stock. In doing so, it reduced the net asset value to account for the Class A units, applied a 15.1 percent minority interest discount and applied a 20.36 percent discount for lack of marketability.

Many in the business appraisal community, including Value Management Inc, disagree with the Court's rejection of the restricted stock studies. These studies, which have averaged around 35 percent, have long been the starting point in the analysis of determining an appropriate discount for lack of marketability. Appraisers have reasoned that a private company with no established market is less marketable than the restricted stock of a public company.

VMI HIGHLIGHTS

Value Management Inc. ("VMI") will sponsor the October 21, 2003 Philadelphia Estate Planning Council's ("PEPC") luncheon held at the Union League in Philadelphia. Donna A. Walker, ASA, CFA, of Columbia Financial Advisors, Inc. (Portland, OR) will give a presentation on "Valuation Discounts for Closely Held Entities."

Andrew Wilusz, ASA has been named to the Board of Directors of the Philadelphia Estate Planning Council. Andrew co-chairs the PEPC's Ethics Committee and serves on several other PEPC committees. Andrew has also recently become a member of the Board of Directors of the Philadelphia Chapter of the American Society of Appraisers. ? On Tuesday, October 7, 2003, Andrew and his wife, Sharon, celebrated the birth of their fourth child. Congratulations Andrew and Sharon!

Joseph M. Egler, CFA, VMI's senior analyst, will be speaking at the Bucks County Bar Association Family Law Section on November 19th, 2003 at 12:30. His topic is "Business Valuation Methodology". In addition, he will be speaking at the Philadelphia Bar Association Family Law Section in November. His topic is "What to look for in a Business Valuation Report."

Ed Wilusz, ASA, CFA spoke at the Mid-Atlantic ESOP Association Conference on September 18. His topic was "The Sale of an ESOP Company. " He also spoke at the Montgomery County Estate Planning Council on September 22. His topic was "Current Valuation Issues for Estate Planners." On June 23 he spoke at the Mercer County Bar Association on the topic "An Overview of Business Valuations in Shareholder Disputes." Ed will be speaking on the topic of "Discounts and Premiums in the Valuation Process." This will be presented to a group of Family Law Attorneys on October 21, 2003.

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COURT CASE LINKS

Estate of Albert Strangi v. CIR

<http://www.ustaxcourt.gov/InOpHistoric/Strangi.TCM.WPD.pdf>

Hackl v. Commissioner

<http://www.ustaxcourt.gov/InOpHistoric/Hackl.TC.WPD.pdf>

Charles McCord, Jr. v. CIR

<http://www.ustaxcourt.gov/InOpHistoric/Mccord.TC.WPD.pdf>

The above court cases require the use of the Adobe Acrobat Reader®. If you do not already have it, you can get this free software by clicking the following link:

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