

VALUE ADDED™ Spring, 2001

## COURT CASE UPDATES

Presented in this newsletter are several recent court cases involving valuation issues that frequently arise. Presented below are the pertinent valuation-related facts. The first four cases involve estate and gift tax; the fifth case involves a Pennsylvania divorce; and the last two cases involve business valuations stemming from shareholder disputes. Also listed are the Internet addresses for the decisions. Some Internet sites post decisions for only a limited time. In those cases, please contact us and we will forward a copy to you at no charge.

### Court Affirms Validity of FLP's Tax Status in Two Separate Cases

In the Estate of Albert Strangi v. CIR., 115 T.C. No. 35 (November 30, 2000) (available at [www.ustaxcourt.gov/inophistoric/STRANGI.TC.WPD.pdf](http://www.ustaxcourt.gov/inophistoric/STRANGI.TC.WPD.pdf)), the issues for decision were: 1) whether the Strangi Family Limited Partnership ('SFLP') should be disregarded for Federal tax purposes; 2) whether SFLP should be disregarded pursuant to tax code 2703 (a)(2) because it is a restriction of the sale or use of property; 3) whether the transfer of assets to SFLP was a taxable gift; and, 4) if SFLP is not disregarded, what is the fair market value of decedent's interest at the date of death.

The Court: 1) ruled that SFLP should not be disregarded for Federal Tax purposes because 'Regardless of subjective intentions, the partnership had sufficient substance to be recognized for tax purposes'; 2) held that the facts of the case were not relevant to section 2703 (a)(2) as the IRS' expert's argument was not supported by the language of the relevant statute or regulation; 3) ruled that there was no taxable gift upon transfer as the IRS' expert mistreated the partnership's assets as if they were assets of the estate rather than the decedent's legal interest in a limited partnership or a corporation; and 4) rejected the results of the Taxpayer's expert (applied a total minority interest/lack of marketability discount of 43.75 percent) as unreasonable given the facts of the case and accepted the IRS' expert's combined discount of 31 percent.

In Ina F. Knight v. CIR, 115 T.C. No. 36 (November 30, 2000) (available at [www.ustaxcourt.gov/inophistoric/KNIGHT.TC.WPD.pdf](http://www.ustaxcourt.gov/inophistoric/KNIGHT.TC.WPD.pdf)), after concessions, the issues for decision were: 1) whether the Herbert D. Knight Limited Partnership ('HDKLP') should be disregarded for Federal tax purposes because it lacks economic substance; 2) whether the size of the gifts was limited to \$300,000 because the transfer document stated that the each of the four gifts would be equal to the number of limited partnership units which equals \$300,000 in value; 3) the size of applicable discounts; and, 4) whether restrictions set forth in HDKLP's agreement are applicable restrictions under tax code 2704 (b) because the partnership's restrictions were alleged to be more restrictive than those permitted by Texas state law.

In this case, the Court: 1) does not disregard the partnership because it has no reason to believe that a hypothetical buyer or seller would disregard it, and that the 'substance and form of the transaction are not at odds for gift tax valuation purposes'; 2) does disregard the \$300,000 per gift limit stated in the transaction document because it is inconsistent; 3) rejects the aggregate discount of 44 percent put forth by the Taxpayer's expert based on 'conclusions which are unexplained or contrary to evidence', further stating that the expert's erroneous factual assumptions cast doubt on his objectivity, ruling that a discount totaling 15 percent for minority interest and lack of marketability is appropriate: and, 4) concludes that section 2704 (b) does not apply in this case, citing its rejection of a similar argument in Kerr.

### Built-in Capital Gains Considered in Marketability Discount

In the Estate of Charles A. Borgatello v. CIR, T.C. Memo 2000-264 (available at [www.ustaxcourt.gov/inophistoric/borgatello.tcm.wpd.pdf](http://www.ustaxcourt.gov/inophistoric/borgatello.tcm.wpd.pdf)), the Tax Court valued an 82.76% interest in a holding company. The company owned real estate, publicly traded stock, and western art. The parties agreed that the holding company should be valued using its net asset value, discounted for factors

affecting its marketability. The Tax Court concluded a 33% discount for lack of marketability. It built up the discount rate as follows: 24% for built-in capital gains, 3% for restrictions on transfer of stock, and 6% for transaction costs associated with the eventual sale of the holding company's assets.

### Partnership's Buy-Sell Viewed as Testamentary Device

In the Estate of Fred O. Godley v. CIR, T.C. Memo 2000-242 (available at [www.ustaxcourt.gov/INOPHISTORIC/Godley.TCM2.TCM.wpd.pdf](http://www.ustaxcourt.gov/INOPHISTORIC/Godley.TCM2.TCM.wpd.pdf)), the Tax Court valued the decedent's 50% interest in five partnerships. Four of the partnerships owned housing complexes for the elderly in connection with Housing Assisted Payments contracts made with the U.S. Department of Housing and Urban Development ('HUD'). The fifth partnership was established to manage the other four partnerships in accordance with HUD requirements.

The partnership agreements for the five partnerships named the decedent's son, who also held the remaining 50% interest in the partnerships, as the managing partner. He had sole control over the affairs of the partnership except for major decisions. Major decisions required the approval of partners holding at least 75% of the partnership's interest.

The decedent's interest was also subject to a buy-sell agreement in favor of the decedent's son. Under the agreement, the decedent's son had the option to purchase the decedent's partnership interests from the estate for \$10,000 each. The decedent's son exercised the option following the death of his father. The estate reported the fair market value of the partnership interests in accordance with the value inferred from the buy-sell agreements.

The Tax Court noted that in order for the agreement to be controlling with regard to value, it must meet the following criteria: (1) the price must be fixed and determinable under the agreement; (2) the agreement must be binding on the parties both during life and after death; and (3) the agreement must have a bona fide business purpose and must not be a substitute for a testamentary disposition. The IRS believed that the agreement met the first two criteria but found that the agreement failed the third criteria. The Tax Court held that the facts of the case - that the agreement was between father and son, and that the agreement fixed the price without an adjustment mechanism - strongly suggested that the agreement was a testamentary device. The Tax Court concluded that the value determined per the agreement did not control for the purposes of estate tax because the agreement was a testamentary device.

In valuing the four partnerships holding real property, the Tax Court considered the applicable discounts. It rejected the estate's contention that a 15% minority discount was applicable. The Tax Court found that 'the terms of the partnership agreements do not reduce decedent's interests to the level of minority interests.'

The Court then considered the application of a discount for lack of marketability. The IRS applied a 10% discount while the estate's expert applied a 25% discount. The Tax Court permitted a 20% discount because the partnership agreements irrevocably named the decedent's son as the managing partner, and the partnership agreements contained a 60-day right of first refusal in favor of the remaining partners.

### Buy-Sell Agreement Not Indicative of the Interest's Value in Pennsylvania Divorce

In *Jeanianne C. Brody v. Michael C. Brody*, 2000 PA Super. 256 (August 28th, 2000) ([www.aopc.org/opposting/superior/out/a22045\\_00.pdf](http://www.aopc.org/opposting/superior/out/a22045_00.pdf)), the Pennsylvania Superior Court considered whether a buy-sell agreement should affect the valuation of a business interest. At the time of the divorce, the husband was an anesthesiologist and a minority shareholder in Beaver Anesthesia Associates, Inc. The husband's interest was subject to a buy-sell agreement which provided that in the event the husband left the company, he would receive his equal share of the company's accounts receivable in cash.

The husband provided an expert who, after considering the buy-sell agreement, valued the interest in Beaver Anesthesia at \$75,380. The wife's expert valued the interest as a going concern, arriving at \$359,243. The trial court accepted the wife's valuation and the husband appealed.

On appeal, the husband argued that the lower court erred in its valuation. He claimed that valuing a partnership interest as a going concern was precluded by *McCabe v. McCabe*, 575 A.2d 87 (Pa. 1990).

The Superior Court found that McCabe was not applicable. It agreed with the lower court and found *Butler v. Butler*, 663 A.2d 148 (Pa.1995) applicable. The Butler court set forth 'guiding principles': buy-sell agreements will not always be beneficial for purposes of ascertaining a spouse's present interest in the business because they 'may not reflect the current situation' and 'an existing buy-sell agreement is to be viewed only as a factor or a possible aide in valuing that interest'. The Superior Court then found that 'the trial court looked at the agreement and found that it was not helpful because it did not include various factors, such as professional goodwill and various buy-ins.' They concluded that, 'since we are not convinced that the trial court's valuation was erroneous, we affirm this portion of the trial court's order.'

#### Fair Value Determination Requires Independent Appraisal

In *Stephen A. Cole v. Kenneth A. Kershaw, et al.*, No. 13904 (August 15, 2000) ([www.corporate-law.widener.edu/documents/opinions/13904-099.pdf](http://www.corporate-law.widener.edu/documents/opinions/13904-099.pdf)) the Delaware Court of Chancery considered whether a breach of fiduciary duty occurred and the damages flowing from that breach.

Stephen Cole and the defendants formed a general partnership to develop a residential community and a golf course in Delaware. Cole held a 12.5% interest in the partnership. The partnership was highly leveraged with bank debt and its operating costs were covered by cash calls. Cole stopped meeting his cash calls and ceased communicating with the other partners. When a bank loan came due, the partnership was unable to satisfy the loan. The partners negotiated a refinancing agreement with the bank in 1993. As part of the refinancing agreement, the partners and their spouses were required to personally guarantee the loan. Because Cole was unresponsive, the remaining partners merged the partnership into an LLC whose shares were held by the partners from the original partnership, except Cole. The LLC purchased Cole's interest for \$2,000. This purchase price was determined by the partners based on an appraisal of the raw land in 1991. When Cole discovered he had been cashed out of the partnership, he brought suit against the other partners alleging breach of fiduciary responsibility.

A Chancery Court found that the partners breached their fiduciary responsibility to Cole by failing to provide Cole with notice of the merger and the elimination of his partnership interest, and by improperly valuing Cole's partnership interest. It found that the partners were 'unaided by any independent or disinterested valuation advice'. It found that the purchase price was unfair because it was based on a 1991 appraisal of the partnership's raw land without ascribing any worth to the properties future earnings capacity. It determined that the amount of Cole's damages should be the value of his proportionate interest in the partnership as of the merger date, adjusted downward to account for the incremental risk Cole inflicted upon the other partners by failing to meet the cash calls or executing the financing agreements.

#### Fifty-Percent Shareholder May be Oppressed

In *Thomas E. Leech v. Robert M. Leech*, 2000 PA Supra 334, ([www.aops.org/opposting/superior/out/a43014\\_00.pdf](http://www.aops.org/opposting/superior/out/a43014_00.pdf)), the Pennsylvania Superior Court considered whether one 50% shareholder could oppress the other 50% shareholder. Thomas and Robert Leech are brothers and were equal shareholders in a corporation. Attorneys for Robert Leech argued that 'a 50% owner of a closely-held corporation cannot be 'oppressed' under section 1767 because the statute is not designed to redress disputes between equals, but rather its purpose is to prevent majority interest from injuring the minority.' The Superior Court found that after Thomas Leech left the company, Robert Leech took steps to diminish Thomas' decision-making ability and, therefore, the brothers were no longer equals. The Superior Court affirmed the lower court's determination that the Robert Leech's (the appellant) actions, while in control of the company, did constitute oppression under section 1767.

#### SEC Amends Rules on Auditor Independence Appraisal Services Impair Auditor Independence

On November 21, 2000, the Securities and Exchange Commission ('SEC') issued amendments to Rule 2-01 regarding auditor independence under the Securities and Exchange Act of 1934. The newest rule updates the existing SEC rules for determining whether an auditor or accountant is independent from the audit client.

Under the new rule, auditors are seen as not being independent of their audit clients if they are engaged in various financial, employment, business and non-audit relationships with their audit clients. Among the

non-audit services provided to audit clients that impair independence are appraisal or valuation services and fairness opinions.

The final version of Rule 2-01 is in effect as of February 5, 2001. It provides for an 18-month transition period for appraisal or valuation services, fairness opinions and internal audit services.

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