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New FLP Case: Taxpayer's First Asset Transfer Merits Discount, But Not Second

Estate of Miller v. Comm'r Internal Revenue, T.C. Memo 2009-119, 2009 WL 1472208 (U.S. Tax Ct.) (May 27, 2009)

In this case the first FLP asset transfer successfully escapes the pull of IRC Sec. 2036, but the second does not.

Perpetuating the father's investment method. The father of the Miller family researched and invested in marketable securities using a specific method of charting stocks for the 26 years following his retirement. When he died in 2000, Miller's stock portfolio was worth roughly $7.6 million.

Miller's 86 year-old widow decided to form an FLP with a portion of the assets. The stated purpose of the FLP was to "buy, sell, and trade in securities of any nature…" and to acquire similar assets and investments to further this goal. As general partner, the eldest son worked 40 hours per week for a monthly fee to manage the FLP securities according to his father's charting method.

About a year later, the widow fell and broke her hip. Within a month she was diagnosed with congestive heart failure, and in early May 2003, her son had her sign a letter transferring all of her remaining assets into the FLP. By the end of the month, she was dead and the FLP used some assets to pay her estate taxes. In 2004, her estate tax return valued the FLP assets at $2.59 million, after application of the 35% marketability discount. The IRS assessed over $500,000 in deficiencies, which the estate paid and then sued for a refund.

FLP has legitimate, non-tax purpose. The IRS did not contest the 35% discount; instead, it argued that the full value of the FLP assets should be pulled back into the estate because the FLP served no legitimate and substantial, non-tax purpose.

The estate claimed that the FLP served the legitimate, non-tax business purposes of asset protection, management succession, centralized management, and continuation of the family's investment strategy. Of all these, the court focused on the family's investment strategy purpose, and was persuaded that Mr. Miller had passed his particular stock-charting method directly to his eldest son, who as general manager continued to monitor the stock market daily, actively discuss the FLP's trades with his family, and provide them with financial advice.

"[An FLP's] activities need not rise to the level of a 'business'…The non-tax purpose behind formation of [the FLP] was to continue Mr. Miller's investment philosophy." In addition, at the time of the first funding, the widow was in general good health, and she retained sufficient assets (over $1 million) outside of the FLP to pay for daily living expenses.

Second transfer was a different story. The "driving force behind the May 2003 transfers was the precipitous decline in [the widow's] health," the court said. The second transfers were driven by the desire to reduce her taxable estate, as they "completely depleted" the widow's resources, including any funds to pay living her expenses or estate tax liabilities. Accordingly, the second transfer of assets did not qualify for the Sec. 2036(a) exception, the court held, and included their full, fair market value in the widow's estate, without any discount.

Tax Court's Adjustment to Reasonable Compensation 'Dizzying and Arbitrary'

Menard v. Commissioner, 2009 WL 595587 (C. A. 7)(March 10, 2009)

The CEO of The Home Depot was paid $2.8 million

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in salary in 1998. The CEO of Lowe's received $6.1 million (neither including bonus). Yet when the CEO of the nation's third largest retail home improvement chain, Menards, posted roughly $20.6 million in salary (including bonus), the IRS stepped in and disallowed $19 million as a corporate deduction. The reason: The IRS claimed that it was a disguised dividend.

The Tax Court applied a unique formula. The CEO, John Menard, founded the Wisconsin based Menards hardware stores in 1962. He worked six or seven days a week, up to 16 hours a day, and was involved in every detail of company operations. Under his management, revenues grew from $788 million in 1991 to $3.4 billion in 1998. The company's return on shareholder equity in 1998 was 18.8%. By contrast, Home Depot returned a 16.1% return on investment that year, and Lowe's rate of return was lower.

Menard owned all the voting shares in the company and 56% of the non-voting shares. He was paid a modest base salary and a portion of a profit-sharing plan; in 1998, he earned $157,500 and $3 million from these sources. A bonus program, adopted by the board of directors in 1973, for his "commanding" management role, awarded him an additional 5% of company earnings (before taxes) at the end of each year. In 1998, the 5% bonus yielded the CEO an additional $17.5 million, conditioned on the IRS allowing its deduction from corporate income.

At trial the IRS not only persuaded the Tax Court that the bulk of the CEO's compensation was excessive, but that because it was conditional and paid at year's-end, it was also intended as a dividend, especially since the company didn't pay formal dividends to other shareholders.

As to the "excess", the Tax Court found that any compensation above $7.1 million for Menard was too much. The court used its own unique formula to arrive at this conclusion:

(1) Divide Home Depot's return on investment (16.1%) by its CEO's salary ($2.84 million);

(2) Divide Menard's return on investment (18.8%) by the result of step (1); and then

(3) Multiply the result ($3.32 million) by 2.13, or the ratio of the compensation of Lowe's CEO to that of Home Depot's CEO.

The appellate court considered the Tax Court's formula an arbitrary and dizzying adjustment. It disregarded differences in the full compensation packages of the three executives being compared (the Home Depot CEO made more than $124 million from 1998-2004) , differences in whatever challenges faced the companies in 1998, and differences in [their] responsibilities and performances (Menard was by far the most active, hard-working).

Not a concealed dividend. The Tax Court ignored the substantial level of risk in Menard's compensation structure, given its direct tie to company earnings. Not to mention the fact that the 5% bonus program had been in place for 25 years before the IRS "pounced," the court said. It did not look like a dividend, because corporate dividends are generally tied to specific dollar amounts and do not serve the same incentive purpose to the passive shareholder.

The Seventh Circuit reversed the Tax Court's decision.

No Legitimate Business Purpose for FLP Precludes Analysis of Discounts

Estate of Jorgensen v. Commissioner, 2009 WL 7920771 (U.S. Tax Ct.)(March 26, 2009)

The Jorgensen estate could not persuade the U.S. Tax Court to find a single legitimate (non-tax) business purpose for its family limited partnership (FLP).

One FLP, two FLP. In 1995, Colonel Jorgensen and his wife funded an FLP with roughly $500,000 of marketable securities. They each became limited partners (LPs) along with their six grandchildren. The colonel and his two children were named general partners. The stated purpose of the FLP was to "pool certain assets and capital for…investing in securities." When the colonel passed away in 1996, his estate attorney recommended that the widow transfer all of their brokerage accounts into the FLP, so that "hopefully your limited partnership interest… will qualify for the 35% discount." The attorney also recommended that she form a second FLP, funded with some $1.8 million in marketable securities. After she died in 2002, the IRS audited the two FLP"s and assessed nearly $800,000 in deficiencies. The estate appealed.

Looking for a legitimate, significant nontax purpose. The Tax Court looked at whether the widow "had a legitimate and significant nontax reason…for transferring her property," which would be sufficient to keep the FLP's from being valued fully as part of her gross estate. The court found the following:

1. No active management. There were no books and records, no formal meetings or minutes. The widow's only "activities" were to make cash gifts to family members and pay taxes and other personal expenses out of the FLP.
2. No financial education or family unity. The family let the investment adviser make most decisions and the promotion of family unity was "no more than a theoretical purpose."

3. No investment philosophy. The “perpetuation of a ‘buy and hold’ strategy for marketable securities is not a legitimate or significant nontax reason for transferring the bulk of one’s assets to a partnership.”
4. No benefit to pooling of assets. Transferring the investment accounts directly could have accomplished the same gift-giving purposes as the FLP’s, without adding any significant expense or oversight, and might have incurred less.
5. Spendthrift tendencies continued unabated. The FLPs did nothing to protect the LP’s, in particular the profligate son, against his own tendencies. The widow’s son borrowed a total of almost $170,000 from the FLPs, but made only two interest payments, and his mother later forgave one of the loans, without reporting it as a gift.
6. Giving equal gifts. Facilitating and simplifying gift giving, alone, is not a legitimate nontax purpose.

The court found that I.R.C. Sec. 2036(a)(1) pulled the FLP assets back into the value of the wife’s gross estate.

In Dueling Daubert Motions, Both Experts’ Evidence Accepted

Uniloc USA, Inc. v. Microsoft Corp., 2009 WL 691204 (D. R.I.)(March 16, 2009)

If after six years of litigation a jury finds that Microsoft had infringed Uniloc’s—a little known software developer—patent on anti-piracy software, the court will be “called upon to determine what a reasonable royalty would be. Before the jury could undertake such an exercise, the court considered the parties’ dueling Daubert motions.

Plaintiff’s expert challenged as arbitrary and junk science. Microsoft claimed that testimony by Uniloc’s damages expert was unreliable, because the valuation: 1) assigned an “arbitrary,” unsupported base value of $10 to price the one-time activation of the patented software; and 2) relied on a “25% rule of thumb” to estimate usage, which is a “junk science method” for calculating royalty rates.

On Microsoft’s claims, the court found that the expert’s derivation of the $10 activation fee was not conjecture or rough approximation, the court found, but based on a figure in an internal Microsoft memo, while the 25% rule has been accepted as a proper baseline from which to start a reasonable royalty analysis in other cases. In both instances, the court said, “Microsoft may rely on cross examination and other tools of the adversary process to address the weaknesses in this testimony.”

The defendant’s expert uses lump-sum calculation. Uniloc challenged Microsoft’s financial expert for asserting that a “paid up,” one-time lump-sum royalty ranging from $3 million to $7 million would be appropriate. The court found that the expert’s opinion “clearly” fell within the bounds of Rule 702 (of the Federal Rules of Evidence) and Daubert. In addition, federal law does not prescribe a single “correct” formula for computing damages in a patent case. “The lack of any ‘running’ aspect to [the expert’s calculation] is important,” the court observed, “but it goes to the weight of his testimony and may be grist for cross-examination. It does not make it unreliable.”

Editor’s note: A jury awarded Uniloc $388 million in patent infringement damages against Microsoft on April 8, 2009. Microsoft intends to appeal the verdict, the second largest in the U.S. this year and the fifth-largest patent jury award in U.S. history.

The Most Credible Experts Admit the Weaknesses in their Reports Up Front

As judges boost their knowledge and more IRS engineers and appraisers become BV-credentialed, they are better able to spot the weaknesses in valuation reports. Should you admit them up front? “Absolutely,” says U.S. Tax Court judge, the Honorable David Laro. “If you don’t address them, the other side will, or the court will have questions.” If an appraiser discusses and analyzes, for example, omitted methods, and explains why they were not applicable to a particular case, they automatically raise the sophistication level of their report.

What other elements must a report have? Ethics, independence, intellectual honesty, and transparency, Laro said. “When you offer a report that is free of bias and advocacy, independently arrived at and transparent, then this is the best we can have.” Howard Lewis, former national program manager of the IRS and current IBA executive director, seconded these requirements, as applied to the Service. “It is not the job of the IRS to be advocates,” he said. IRS appraisers and examiners are “charged with the responsibility to be fair, honest and unbiased.” At the same time, they regularly see only the worst-case appraisals, and this system-bias led even Lewis to develop a bias early in his career, which he focused on correcting in later years, in both himself and his fellow engineers. The point: “Understand the perspective of the IRS,” he said.

VMI Highlights

- Andrew Wilusz spoke at the Lehigh Valley Bar Association on September 2. The topic was, “The Five C’s of Ethics for Estate Planning Practioners.”
- **VMI** sponsored the Philadelphia Estate Planning Council luncheon on September 15 at the Union League. The speaker was Robert B. Wolf, Esq. of Tener, Van Kirk, Wolf & Moore, P.C. His topic was, “Total Return Trust in 2009—What Total Return? Where Did My Trust Go?” Please contact us if you would like a copy of Mr. Wolf’s presentation.
- **VMI** was a conference sponsor at the 14th Annual Multi-State ESOP Conference Program on September 16-17, 2009 at the Hilton Scranton & Conference Center. Ed Wilusz led a session on Valuation in Uncertain Times. In attendance were participants from New Jersey, New York, Pennsylvania and Delaware.
- **VMI** will sponsor the NCEO’s, “Get the Most Out of Your ESOP” seminar and “The Downturn/The Upturn and ESOPs?” meeting. Both are being held in Philadelphia, PA on November 2-4. Ed Wilusz will be presenting at both meetings. Anyone interested in attending please contact Susan Wilusz for more information.
- **VMI** will be sponsoring the PBI’s 16th annual Estate Law Institute. It will be held at the Convention Center in Philadelphia, PA on December 10 & 11.

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 smw@valuemanagementinc.com.

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