

Valuing Stock Options? What Will the IRS say?

How can auditors and corporate executives better understand fair market value determinations under IRC Sec. 409A in light of prior fair value for financial accounting reports or transactions? Valuation specialists suggest reviewing the prior fair value conclusions for the reasonableness of their standards and outcomes, especially in today's economic market, and then checking to see whether they are consistent with fair market value determinations pursuant to current IRS standards. In addition, consider the following:

- **Subsequent events.** The IRS currently supports considering subsequent events if they are reasonably "known or knowable" at the valuation date and are relevant to the valuation. See Estate of Noble (Tax Ct. Memo 2005).
- **Appraisal penalties.** The IRS has explicitly stated that appraisal penalties will apply to valuation reports that are either over or undervalued. (Penalties for undervalued valuations were not previously clear.) Further, the IRS is working on establishing clear standards for what constitutes a "qualified" appraisal/ appraiser.
- **Enforcement.** IRS enforcement procedures are still in preliminary stages; the Service is simply trying to review as many valuation reports as possible and is selecting those that appear, on the surface, to be unreasonable or to lack credibility. In the context of 409A, those that lack independent valuation analysis may raise red flags.
- **Internal valuations.** In the context of 409A, the Service generally questions whether company-generated valuations even qualify as appraisals. One page of management analysis is certainly not sufficient and requires adequate support and substantiation, just like any qualified appraisal.
- **Pre-audit conversations.** Another benefit of an independent valuator: The IRS may seek additional information from the preparer of the 409A valuation before beginning a full-scale audit, which will still take place at the taxpayer level.
- **Cost or current value approach.** The IRS does not categorically reject any methodology,

but instead applies the general standards of reasonableness, relevance, and credibility. Above all, a report must clearly identify the valuation assumptions and the methods by which they were derived..

- **Income and market approaches.** The income approach should evaluate the path to profitability; the market approach typically incorporates a "comparable" transactions. Note: Given current market conditions, analysts should check their traditional reliance on prior transactions, and poll investors for their perspectives on the latest financing round.
- **Stock option pricing models** should capture: i) the effect of the economy and its influence on early stage companies and option grants; ii) a slow IPO market; iii) increased venture funding in a depressed economy; iv) issued and outstanding options; v) companies that have yet to produce any products; vi) management incentives, such as executive shares; vii) "down rounds" and mandatory subsequent rounds of financing, originally contemplated as part of a venture capital investment plan; and viii) subsequent rounds of "arm's length" financing if all of the same investors participate.

Ultimately, 409A valuations rely on a thorough, fact-intensive inquiry of early-stage valuations, supported

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by good judgment and analysis. Circumstances will particularly drive complex matters: So much depends on factors such as the strength of the company, the strength of its investors, the nature of the industry, and the cycle in the economy.

Two Taxpayer Victories Demonstrate Winning Facts for FLPs

As textbook examples of how to form, fund, and operate a family limited partnership (FLP)—sufficient to value various assets (including publicly traded securities, real estate, and restricted holdings) at substantial discounts for federal estate tax purposes—the Murphy and Black cases make excellent reading for attorneys and financial advisors alike.

Legitimate business purpose proves critical. The Murphy Oil Corp. grew from a small family-owned business into a \$2 billion international conglomerate. During the 1990s, Mr. Murphy established an FLP with \$89 million in company stock plus bank and real estate holdings. Importantly, this represented only half his net worth and he never mingled his personal assets with the FLP's. Overall, the father retained a 95% limited partnership interest in the FLP, with his two sons in charge of daily operations.

For five years, the FLP traded assets, managed employees, held regular meetings, and prepared regular statements. It made only two distributions, with appropriate adjustments to the partners' capital accounts. After the father died unexpectedly in 2002, the IRS cited over \$34 million in tax deficiencies and the estate sued for a refund. In *Murphy v. U.S.*, 2009 WL 3366099 (W.D. Ark.) (Oct. 2, 2009), the federal court found the FLP was created to:

- Pool and invest the family assets according to the father's philosophy;
- Pass management responsibility onto the next generation;
- Enable the father to gift interests in the FLP while the underlying assets stayed under central management;
- Educate the father's heirs about wealth acquisition, management, and preservation; and
- Protect the family assets from creditors, divorce, and dissipation by future generations.

Moreover, the FLP was an active, ongoing entity that respected partnership formalities. Based on these strong facts, the court concluded the FLP was established for legitimate and significant non-tax purposes, sufficient to exclude the value of its underlying assets

from the father's gross estate per IRC Sec. 2036(a)(1) (bona fide sale exception for adequate consideration).

To value Mr. Murphy's 95% LP interest, the court considered the parties' credentialed experts, who took the net asset values of the underlying interests before applying Rule 144 and blockage discounts as well as minority and marketability discounts. Their results diverged widely, but in each instance the court found the taxpayer's expert to be more credible, largely because he considered specific qualitative factors, including the FLP's substantial cash balance and the relative holding period, risk, distribution policy, and transfer restrictions of its assets. After adopting all the estate's discounts, the court found the fair market value of the 95% Murphy LP interest to be \$74.5 million—and ordered a complete tax refund.

Another winning story. Samuel Black worked his way up from peddling newspapers on the street to senior vice president and second largest shareholder of the Erie Indemnity Co., a national insurance company. To pool, protect, and prolong his family's wealth, Mr. Black formed an FLP in 1993, retaining a 1% general partnership interest with LP interests dispersed among his son and his grandsons' trusts, with substantial restrictions. He funded the FLP with Erie stock worth \$80 million, which increased to \$318 million over the next seven years. The partnership distributed 92% of Erie dividends, with appropriate adjustments to the partners' accounts, and the Blacks never dipped into the assets for their own expenses.

Mr. Black died in 2001 and Mrs. Black's death followed soon after. The IRS assessed deficiencies totaling over \$83 million on their estate tax returns. The parties resolved all the valuation issues prior to trial, leaving only the Sec. 2036(a) issue: i.e., whether the stock transfers were bona fide, for a legitimate non-tax purpose. The taxpayer claimed the following in support:

- The FLP's net asset value increased dramatically through active investment according to Mr. Black's "buy and hold" philosophy;
- The transfer restrictions successfully prevented Mr. Black's son from dissipating his assets in divorce and his grandsons from reaching their stock, even when their trusts terminated; and
- The Black family's consolidated position allowed it to maintain a seat on the Erie board.

The taxpayer also cited *Estate of Schutt v. Comm'r* (T.C. Memo 2005), in which the Tax Court validated an FLP for its "unique circumstances"—primarily its pooling of assets according to the founder's investment philosophy, to preserve them against claims from creditors, divorcing spouses, and irresponsible heirs. The IRS tried to distinguish *Schutt* by claiming that Black's concerns for his Erie holdings was either "ill-founded" or insignificant. The court was persuaded

by the precedent, however, and the similar “unique” facts of this case. Moreover, the FLP respected partnership formalities, including appropriate adjustments for contributions and distributions. Accordingly, the court held that the fair market value of Mr. Black’s FLP interest, rather than the fair market value of the underlying Erie stock, was includable in his gross estate.

Back-to-back Defined Value Cases Deliver Double Punch to IRS

First came *Estate of Christiansen v. Commissioner*, 2009 WL 3789908 (C.A.8)(Nov.13, 2009), in which the Eighth Circuit upheld an estate’s formula disclaimer of assets. Next, the Tax Court strongly affirmed the use of defined value clauses in *Estate of Petter v. Commissioner*, 2009 WL 4598137(U.S. Tax Ct.)(Dec. 7, 2009). This “one-two” punch may have knocked out the IRS’s strong public policy arguments against these types of structured gifts, representing an important recent development in estate and tax planning.

Did the Tax Court wait for the feds? The Tax Court was deciding *Petter* while *Christiansen* was still pending in the Eight Circuit. Judge Holmes—who wrote the original opinion in *Christiansen* and was preparing to write *Petter*—probably waited to see how the Eighth Circuit would rule, because he issued *Petter* just about three weeks later.

In *Christiansen*, the taxpayer’s daughter structured a disclaimer of her inheritance to keep part of it and give the rest to charity. The formula was complicated: the numerator was the fair market value of the gift, less \$6.35 million, and the denominator was the fair market value of the gift on a certain date, “as finally determined for federal estate tax purposes.”

“The Commissioner quibbled with this clause because he said it worked to reallocate gifts after an audit,” Judge Holmes observed, discussing the case in *Petter*. The IRS also invoked its standard arguments to defeat the additional charitable deduction that resulted from the daughter’s disclaimer; i.e., the adjustment clause was a condition subsequent and contrary to public policy. “But we sided with the taxpayer,” Holmes wrote (and so did the 8th Circuit).

Specifically, the charitable transfer was not contingent because it remained constant (25% of any excess over \$6.35 million) regardless of the estate’s ultimate valuation. Further, public policy generally fa-

vors charitable gifts, and any public policy exceptions to the Tax Code must be “severe and immediate.” Any fears that charities may be abused by tax-avoiding donors were unfounded, Holmes added. Executors, charitable foundation directors, and state attorneys general “would all have some incentive to police low-ball appraisals.”

Further, the court distinguished *Christiansen* and also *Petter* from precedent concerning “savings clauses”—adjustment clauses that require any gift subject to tax to revert back to the donor. “The distinction is between a donor who gives away a fixed set of rights with uncertain value—that’s *Christiansen*,” Holmes observed, “and a donor who tries to take property back.” The former are fine but the latter are void, he said. “But figuring out what kind of clause is involved in this case [*Petter*] depends on understanding just what it was that [the taxpayer] was giving away.”

A complicated plan. In *Petter*, the taxpayer inherited UPS stock worth over \$22 million. To preserve the wealth for her two children and for charity, she transferred the stock to a family limited liability company (LLC), establishing grantor trusts for the children. Over the next two years, the mother gave substantial LLC interests to the trusts by formula allocation, so that they ultimately received units worth \$4.08 million “as finally determined for federal gift tax purposes,” the excess

to be assigned to two charitable foundations. (The charities specifically renegotiated their transfers to maintain voting, member interests.)

The taxpayer obtained a reputable appraiser to value the transfers at the time of the original gift. After comparing the LLC to closed-end mutual funds and applying a 46% marketability discount, he reached a unit value of \$536.20. Based on that appraisal, the taxpayer’s attorney allocated the units among the donees and the taxpayer reported the transactions on her gift tax return, which attached detailed disclosures, including the appraisal. After an audit, the IRS reduced the discount to 29% and claimed the formula clauses were invalid, thus denying any larger charitable deduction triggered by their reallocation.

The taxpayer died before trial and her estate negotiated a 35% discount with the IRS. The parties disputed only the size of the charitable gift: Was it the number of shares before or after reallocation? The answer turned on whether the formula allocation clause was valid.

Precedent and planning tips. The formula alloca-

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tion provisions were not “void as contrary to public policy, as there was no ‘severe and immediate’ frustration of public policy as a result, and indeed no overarching public policy against these types of arrangements in the first place,” the Tax Court held. Further, it allowed a gift tax charitable deduction for the year of the original transfer, rather than in the year of final determination, because no matter what triggered the reallocation, subsequent events would not undo the transfer. The plain language of the documents showed that the donor transferred an ascertainable dollar amount rather than a specific number of shares.

Finally, the charities were not “passively helping a putative donor to reduce her tax bill,” the court said, but actively negotiated for an equal voting and oversight role in the LLC. The foundations’ directors were bound by their own fiduciary duties, and could lose their tax-exempt status if they “acted in cahoots with a tax-dodging donor.” In conclusion, “We have no doubt that behind these complex transactions lay [the taxpayer’s] simple intent to pass on as much as she could to her children and grandchildren without having to pay gift tax, and to give the rest to charities in her community.”

Given this “knockout” blow to long-standing IRS policy, estate planners, financial advisors, and attorneys for all parties (including charities), should work closely to plan and implement the formula allocation process, including transfer documents that:

- Make the transferees substitute members or partners of the family LLC
- Clarify the rights of the parties following reallocation
- Transfer the block assets to a trust for formula allocation by a trustee
- Use formula clauses that require a fiduciary review of the value allocation
- Require reporting as a formula transfer (rather than a specific number of shares)
- File comprehensive disclosures with gift tax returns
- Retain a qualified appraiser to value the unit/shares at the original allocation

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