

LLC and limited partnership transfers are valid to reduce estate tax

***Kimbell v. Commissioner*, 2004 U.S. App. LEXIS 9911 (May 20, 2004). Judge Davis.**

In this estate tax case, the Fifth Circuit vacated and remanded the district court's granting of summary judgment to the Commissioner on the grounds that that the transfer under IRC §2036 was a bona fide sale for full and adequate consideration.

Facts

In January 1998, the decedent's living trust, along with her son and daughter-in-law, formed an LLC. The trust contributed \$20,000 for a 50% interest, while the son and daughter-in-law contributed \$10,000 each for a 25% interest. Later that month the decedent's living trust and the newly formed LLC formed a limited partnership. The living trust contributed \$2.5 million worth of cash and assets in exchange for a 99% limited partnership interest. The LLC contributed \$25,000 for a 1% general partnership interest. The decedent's son managed both the LLC and the limited partnership. Decedent continued to hold approximately \$450,000 in assets for living expenses outside of the LLC and limited partnership.

Valuation evidence

The estate's federal return claimed a 49% combined minority and lack of marketability discount. The tax return concluded that the fair market value of the decedent's interest in the limited partnership was \$1.2 million and the fair market value of the LLC interest was \$17,000.

The IRS audited the estate and concluded that the assets were subject to IRC §2036(a), which recaptures certain assets prior to death.

Trial court findings

At trial, the IRS successfully argued that the transferred assets could be recaptured because the transaction was not a bona fide sale for full and adequate consideration. The district court, which defined an arm's-length transaction as one involving "two parties who are not related..." concluded that the transaction was not at arm's length because the parties were related and therefore the transaction was not bona fide.

The district court accepted the IRS's conclusion, and granted partial summary judgment on that rationale.

Holding on appeal and rationale

In its opinion vacating the district court's opinion, the Fifth Circuit stated, "[t]he government's inconsistency argument ... is a classic mixing of apples and oranges: The government is

attempting to equate the venerable "willing buyer-willing seller" test of fair market value (which applies when calculating gift or estate tax) with the proper test for adequate and full consideration under § 2036(a). This conflation misses the mark: The business decision to exchange cash or other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid — a classic informed trade-off."

The court of appeals concluded that the facts of the case supported the contention that the transaction was bona fide. They included:

- (1) Mrs. Kimbell retained sufficient assets outside the Partnership for her own support and there was no commingling of Partnership and her personal assets...
- (2) Partnership formalities were satisfied and the assets contributed to the Partnership were actually assigned to the Partnership...
- (3) The assets contributed to the Partnership included working interests in oil and gas properties which do require active management...
- (4) David Kimbell and Michael Elyea advanced several credible and unchallenged non-tax business reasons for the formation of the Partnership that could not be accomplished via Mrs. Kimbell's Trust...

Specifically, the court found that a living trust would not provide legal protection from creditors as a limited partnership would, because with the partnership, all the capital assets could be pooled, thereby reducing administrative costs and keeping all accounting functions together.

The court of appeals concluded that the transaction was bona fide for full and adequate consideration as a matter of law and remanded to the circuit court the issue of whether Mrs. Kimbell's interest in the Partnership was an assignee interest or limited partnership interest.



Abusive S corp ESOPs must be disclosed as tax shelters

Revenue Ruling 2004-4

Per Revenue Ruling 2004-4, S corporation Employee Stock Option Plans (ESOPs) that are being used to allow one or more taxpayers to avoid current taxation must be listed for tax shelter disclosure requirements. This listing requirement applies to those transactions in which the ownership structure of the S corp is designed to allow one or more taxpayers, each operating a business for that taxpayer's own benefit that is a qualified subsidiary of the S corp (a "QSub"), to take advantage of the tax-exempt status of the S corp that results for the ownership of its outstanding stock by the ESOP.

The ownership structure thus avoids current taxation of the profits of each of taxpayer's separate business, while each taxpayer retains the right to at least 50 percent of the business through the right to acquire shares in the QSub. Because the profits of each business are being segregated and accumulated in each taxpayer's QSub, the ESOP is owner of the business only in form, not in substance, and does not—according to the IRS—provide benefits to rank-and-file employees that

reflect its ownership share in the S corp (IRC § 409(p) limits the tax benefits of ESOPs maintained by S corps unless the ESOP provides meaningful benefits to rank-and-file employees).

Effective dates and penalties

This revenue ruling applies for plan years ending after October 20, 2003, but is not effective before March 15, 2004 if (1) all interests held by the taxpayer in the QSub are distributed to the taxpayer before that date, and (2) the taxpayer has not been a participant in the ESOP at any time after October 20, 2003 and before March 15, 2004. For purposes of the excise tax under IRC § 4949A (which imposes a 50 percent excise tax in certain cases) a taxpayer's interest in a QSub that constitutes synthetic equity will be disregarded to the extent such interest is distributed to the taxpayer as compensation on or before March 15, 2004. Persons required to register these tax shelters—or similar arrangements that meet the criteria set forth in the ruling—who fail to do so may be subject to penalties.

Continued enjoyment of property leads to disregard of FLPs

Estate of Abraham v. Commissioner, 2004 Tax Ct. Memo LEXIS 41(February 18, 2004). Judge Ruwe.

The issue in this estate tax case was whether three family limited partnerships (FLPs) should be respected for estate tax purposes.

Facts

The decedent, Abraham, had numerous properties that were placed in three FLPs for purposes of estate planning. Decedent continued, by way of her appointed guardian, to benefit from those properties until her death, exclusive of the other partners, who were her children.

The estate engaged **Michael Lipof**, a real estate consultant, to value the FLPs for the estate tax return. In doing so, Lipof applied a discount of 30% to 40 % to the asset value of each FLP to determine the fair market value of the FLPs.

The IRS filed a notice of deficiency, claiming that most of the assets held by the FLPs should be included in Abraham's gross estate under Section 2036.

Tax Court findings and rationale

The Tax Court noted that the decedent by definition violated Section 2036 by continuing to enjoy the property held by the FLPs. "Possession or enjoyment of the property transferred is retained where there is an express or implied understanding among the parties at the time of the transfer, even if the retained interest is not enforceable."

The Tax Court concluded that the FLPs were "merely a testamentary vehicle employed to shift her assets to future generations while maintaining her continued right to benefit from the FLP interests transferred. This is precisely the type of situation for which Section 2036 was created." The Tax Court disregarded the FLPs and valued the property held in the FLPs at full fair market value.

Editor's note: For an in-depth discussion of this case and the Tax Court's handling of recent cases involving Section 2036, see "Abraham and Hillgren: Different Approaches to Section 2036(a) Valuation," in the May 2004 BVUpdate.

2004 S&P Risk Premium Report available; New feature added application examples

Standard & Poor's Corporate Value Consulting Risk Premium Report 2004 is now available. The new report has data updated through year-end 2003.

The new update includes for the first time an extensive example illustrating the application of the results to the required rate of return on equity for a hypothetical company.

The report has two parts. In part one, companies are sorted by size, breaking the NYSE universe into 25 size-ranked portfolios and adding AMEX and NASDAQ companies. These portfolios are limited to companies with a track record of profitable performance. There is also a separate "high financial risk" portfolio composed of companies that are losing money, have high

leverage, or are in bankruptcy.

Part two documents the relation between historical rates of return and three measures of company risk based on accounting information. The companies are sorted by the measure of risk, with the universe broken into 25 risk-ranked portfolios.

This update includes an extensive example illustrating how the data can be used in estimating a required rate of return on equity. It also includes tables of equity premiums over the Capital Asset Pricing Model (CAPM), as well as a correction for the "delisting bias" in the database of the Center for Research in Security Prices. Also included are data for companies ranked by total assets. The report can be purchased at Ibbotson's Cost of Capital Center at www.ibbotson.com.

Marketability discount not appropriate where comparables were also closely held companies

Hanson v. Hanson, 2004 Ore. App. LEXIS 230 (March 10, 2004). Judge Hasleton.

One issue in this marital dissolution was the fair market value of **Northwest Stamping, Inc.** (NSI), a closely-held S corporation. The court of appeals determined the trial court's valuation was proper and upheld its ruling.

Facts

The parties purchased NSI in 1991, during the marriage. NSI designs and produces high-tech components using precision stamping machinery for various industries. In 1999 the parties jointly hired **William Mason** to value the company in connection with their separation. In 2000 wife filed for dissolution.

Valuation evidence

At trial both parties offered the testimony and reports of valuation experts. Mason and **Donna Walker** testified on behalf of wife. William Holmer testified on behalf of husband. All the experts prepared reports using a combination of the capitalization of earnings method (income approach) and the comparable transaction methods (market approach). The valuation conclusions of the experts and the court are shown in Table 1.

TABLE 1: EXPERTS' VALUES & COURT'S CONCLUSIONS

Expert	As of date	DLOM	FMV
Mason (jointly retained)	Sept. 30, 1999	None	\$6.9 million
Mason (for wife)	Dec. 31, 2000	None	\$5.7 million
Walker (for wife)	Feb. 2001	None	\$5.9 million
Holmer (for husband)	Dec. 31, 2000	25%	\$3,646,731
Court	Dec. 31, 2000	None	\$5.7 million

Only Holmer applied a discount for lack of marketability.

Trial court findings

The trial court adopted Mason's December 31, 2000, valuation of the company holding that:

Despite the able arguments of Respondent's counsel, I find that a marketability discount is not appropriate in this particular case. ... with regard to the argument that the Court of Appeals in Tofte and Tofte, 134 Ore. App. 449, 895 P.2d 1387(1995) mandates that a marketability discount be applied to all controlling interests of non-publicly traded companies, I reject that argument. The passage cited is in a footnote and the case involved a minority interest, not a majority interest. That this topic is hotly debated is clear from the record in this case.

Holding on appeal and rationale

The court of appeals affirmed the trial court's opinion. The court was careful to point out that marketability discounts could be applied in cases where the interest was a majority interest stating, "[T]he court did not hold that a marketability discount can never be applied-only that, in the circumstances of this case, such a discount would be improper. The trial court was correct in that conclusion." The court indicated that a discount for lack of marketability would be appropriate in valuing a closely held company where comparables that were used were public companies. In this case, however, all the comparables used were closely held companies.

The court also discussed the distinction between a discount for lack of marketability and a minority interest discount.

Withdrawing partner entitled to percentage of nets assets of dissolved partnership

Lucke v. Kimball, 2004 Tex. App. LEXIS 604 (January 22, 2004). Judge Castillo.

The issue in this partnership dissolution was whether the withdrawing member of the partnership was entitled to the statutory value of her partnership interest or the Partnership Agreement's mandated \$600.

The partners were Kimball with a 32.45% interest and Lucke with a 67.55% interest. Several partners who had previously withdrawn were paid for their partnership interest based on their percentage interest in the assets of the partnership.

Valuation evidence

At trial, Kimball presented expert testimony that valued her partnership interest at \$126,885. The expert based his valuation on the partnership's assets, which included cash, accounts receivable, and work-in-progress.

Jury award and appeal

At trial, the court instructed the jury that Kimball was entitled to be paid her percentage interest in the net value of the dissolved partnership. The jury awarded Kimball \$85,000 for her partnership interest, plus \$36,735 in attorney's fees and costs.

Lucke appealed, arguing that under the Partnership Agreement she was only entitled to \$600 because the partnership was not dissolved pursuant to a vote of 51% of the partners.

The appeals court affirmed the trial court's jury instructions and the jury's award, finding that the partnership dissolution was governed by the Texas Uniform Partnership Act, which took precedence over the Partnership Agreement on the issue of a partner's right to withdraw. Because the jury's award was supported by the valuation testimony of Kimball's expert, it was not erroneous.

Former partner must compensate for goodwill attached to ongoing business at same location

Perry v. Rogers, 2004 Cal. App. Unpub. LEXIS 2733 (March 25, 2004). Judge Benke.

The issue in this partnership dissolution was the division and valuation of goodwill in a barbershop.

Facts

Perry and Rogers had operated a barbershop under an oral partnership agreement for 20 years. During that time, and as a requirement of the landlord, improvements had been made by Rogers to the jointly leased property.

In 2001, the landlord informed them that the lease would not be renewed unless substantial improvements were made to the property. At that time, Rogers informed Perry that he wanted to dissolve their partnership.



Rogers and Perry each attempted to become sole tenants of the property. Rogers' application was approved by the landlord. Rogers then informed Perry he was no longer welcome at the barbershop.

Valuation evidence

The court of appeals noted

that, "the trial court's valuation was based in large measure on an appraiser's opinion as to the market value of the barbershop as an ongoing business." The specifics of the appraiser's opinion can only be deduced from the trial court's calculations.

Trial court findings

The trial court found that the gross value of the partnership was \$104,000. The court deducted \$26,000 for the amount of improvements that needed to be made in order for Rogers to continue with the business and then deducted a marketability discount of \$19,900 to arrive at \$58,100. The court then divided that in half to arrive at the value of Perry's interest, \$29,100 (it is unclear how the court arrived at this figure rather than \$29,050).

The trial court noted, "the defendant [Rogers] carried on the business exactly as though he were the purchaser of it."

Holding on appeal and rationale

The court of appeals affirmed the trial court's holding, stating that it was not relevant that the remaining partner was innocent of improper behavior or breach of duty. Rogers stayed in the same location under a similar name and continued to operate the barbershop as an ongoing business. "[H]e in fact was making use of a partnership asset: its value as an ongoing enterprise." The court of appeals concluded that under those circumstances Rogers was required to pay Perry half the value of the barbershop as an ongoing business.

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