



MANAGEMENT
PLANNING, INC.

Princeton, New Jersey
Founded 1939

Series XXX

Recent Cases Inside:

MURPHY.....p. 2
No. 07-CV-1013 (U.S. Dist. Ct.
W.D. Ark). Filed October 2, 2009.

PIERRE.....p. 2
133 T.C. No 2. Filed August 24,
2009.

LINTON.....p. 2
2009 WL 1913255 (W.D. Wash).
Filed July 1, 2009.

LITCHFIELD.....p. 4
T.C. Memo. 2009-21. Filed January
29, 2009.

GROSS.....p. 5
T.C. Memo. 2008-221. Filed
September 29, 2008.

BERGQUIST.....p. 5
131 T.C. No 2. Filed July 22, 2008.

HOLMAN.....p. 6
130 T.C. No. 12. Filed May 28,
2008.

ASTLEFORD.....p. 6
T.C. Memo. 2008-128. Filed May 5,
2008.

MIROWSKI.....p. 7
T.C. Memo. 2008-74. Filed March
26, 2008.

BUSINESS VALUATION REPORT

Recent Valuation Developments

When potential new clients first contact us, we typically ask how they plan to use our valuation services. The answer is often estate and gift tax planning and/or reporting because it's what we have been known for these past 70 years and remains a large part of our business. In fact, despite the continuing debate in Congress about the future of the estate tax and possible elimination of valuation discounts, the demand for solid, well reasoned and thoroughly documented valuations remains strong. We have found the good will from quality tax valuation work leads to assignments in other disciplines, namely financial reporting, corporate planning, investment banking, etc.

Continued volatility in the public markets, lower asset values and historically low interest rates make this an excellent time to proceed with tax planning strategies. We understand clients may hesitate to act in uncertain times, but the price of inaction remains high.

We note that during a recent California Tax Bar and Tax Policy Conference, Kyle Martin, an IRS Supervisory Attorney, indicated the IRS has renewed its focus on estate and gift tax filings. In California alone, 14 new estate and gift tax attorneys have been hired, with more expected to join the Service in 2010. This suggests that the need for a detailed, supportable valuation as an integral part of the filed return seems greater than ever.

We look forward to being of service to you and your clients and can be reached at any of our offices listed on the back page.

§

The cases discussed below involve a number of current issues. They are:

- ♦ *Murphy and Mirowski* – Good facts avoid IRS 2036(a) argument
- ♦ *Pierre* – Approval of transfer of interests in a single member LLC
- ♦ *Gross and Linton* – Application of indirect gift – step transaction doctrines
- ♦ *Litchfield* – Treatment of unrealized capital gains taxes for C corporation holding companies
- ♦ *Bergquist* – IRS reliance on restricted stock studies to achieve 45% discount for lack of marketability
- ♦ *Holman* – Disregard transfer restrictions in a partnership agreement under Code Section 2703
- ♦ *Astleford* – Approval of tiered valuation discounts

MPI was valuation expert in both *Gross* and *Holman*. The taxpayer prevailed in *Gross* but not in *Holman*. We await the results of a *Holman* appeal.

Murphy v. U.S., Case No. 07-CV-1013 (U.S. Dist. Ct. W.D. Ark).
Filed October 2, 2009.

Charles Murphy was a successful oil, banking and real estate investor from Arkansas who received excellent FLP advice on formation, funding, gifting, family participation, no asset commingling, etc. and followed through beautifully during the five year period before his death in 2002. As in *Mirowski*, *Schutt*¹ and *Stone*², an IRS 2036(a) argument failed because there were strong non-tax reasons (centralize management, perpetuate investment philosophy, pool and preserve family “legacy” assets) for creating the partnership.

Although Mr. Murphy retained sufficient assets to live comfortably, his estate was forced to borrow from the partnership in order to pay a portion of the estate taxes. The IRS said interest on the loan was not deductible since it resulted from undervaluing assets by means of “an unnecessary estate tax-avoidance transfer...that drained his future estate of liquid assets.” Having ruled in the estate’s favor on 2036(a), the Court said the expense was “reasonable and necessary” and therefore allowed the deduction.

The estate’s valuation experts did well, supporting a combined 41% discount for the FLP. Unlike many Tax Court decisions where the judge’s valuation conclusion is different from that of the taxpayer and IRS (e.g. split the difference), U.S. District Court Judge Barnes agreed with the estate on virtually all valuation issues.

Pierre v. Commissioner, 133 T.C. No 2. Filed August 24, 2009.

Suzanne Pierre transferred her entire interest in her single-member New York LLC by way of gifts and sales of noncontrolling interests to trusts for her son and granddaughter. Discounts were used in valuing the interests. Based on IRS “check the box” regulations dealing with classification of business entities for federal tax purposes, Ms. Pierre’s LLC was a “disregarded entity separate from its owner.” The IRS argued the transfers were of LLC assets, not LLC interests.

A majority Tax Court opinion favored Ms. Pierre. Property rights are determined under state law, not federal tax law. New York law recognizes an LLC as an entity separate and apart from its owner. Its members have no interest in specific property of the LLC.

Other issues to be addressed in a later opinion are (1) application of the step transaction doctrine and (2) appropriate valuation discounts.

Linton v. U.S., 2009 WL 1913255 (W.D. Wash). Filed July 1, 2009.

This opinion is a good review of recent cases involving asset-based family entities where formation, funding and gifting seemed so connected that the IRS challenged with indirect gift and/or step transaction arguments.

Indirect Gifts

Shepherd³ An attempt by the taxpayer and his wife to transfer land to a general partnership was not effective until the next day when the partnership was formed by the taxpayer (50%) and his two sons (25% each). The sons contributed nothing in exchange for their interests. The Court decided that allocations of 25% of the land to each son’s capital account (to which they would be

¹ *Schutt v. Comr.*, T.C. Memo 2005-126.

² *Stone v. Comr.*, T.C. Memo 2003-309.

³ *Shepherd v. Comr.*, 115 T.C. 376 (2000), aff’d 283 F. 3d 1258 (11th Cir. 2002)

entitled on dissolution) were really indirect gifts of 25% undivided interests in the land, not gifts of partnership interests.

Senda⁴ The taxpayers were unable to prove that their transfers to two family limited partnerships occurred before gifts of limited partnership interests to children's trusts were made. Just as in Shepherd, the contributed property (MCI WorldCom stock) enhanced the value of the trusts' partnership interests and was therefore the subject of indirect gifts to the trusts.

Jones⁵ and **Gross**⁶ Unlike Shepherd and Senda, in each of these cases contributed property was properly reflected in the prospective donor's capital account before any gifts of limited partnership interests were made. Accordingly, indirect gift arguments failed.

Step Transaction Doctrine

Holman⁷ The taxpayers made gifts of limited partnership interests six days after forming and funding the partnership with Dell stock. The IRS argued formation, funding and gifting were a series of transactions which should be "stepped" together and treated as a single transaction. The Court disagreed, pointing out the risk of change in value of a limited partnership interest during the six day period due to fluctuations in Dell's stock price.

Gross⁶ Formation of the limited partnership was on July 15. Funding with marketable securities and cash took place over the next few months and was completed by December 4. Gifts of limited partnership interests were made on December 15. The eleven day passage of time and "status" of "common shares of well-known companies" were enough for the Court to rule the step transaction doctrine did not apply.

Linton

WFLB, LLC was formed in November, 2002. Everything else happened on January 22, 2003 (and in no particular order), namely, funding the LLC with cash, real estate and securities, creating the children's trusts and gifting LLC interests to the trusts. Not surprisingly, the Court relied on Shepherd and Senda and said the inability to show some logical sequence of events meant that indirect gifts of LLC assets had been made.

The Court used three tests to determine that January 22 events were really one transaction:

1. Binding commitment test - All three steps (funding, creating trusts, gifts) took place at the same time. The Lintons would not undertake one step without binding themselves to do another.
2. End result test - All three steps were "prearranged parts" of a transaction recommended by advisors to result in gift tax savings. A portion of Mr. Linton's deposition is in the opinion:

"Well, it started out Stacy and I were using our lifetime exemptions, and somewhere along the way, with my team of experts, they came up with this thing that people do in my situation and they discount it because as managers, we control it, and what a willing buyer will pay to a willing seller, who is going to buy a hundred percent of someone's share if they can't touch it or feel it or control it, so there's some proven way that they go out and they discount this stuff. Well, it was news to me.... They said somewhere between 40 and 49 percent discounting based on the blend of assets that you're proposing so,

⁴ *Senda v. Comr.*, T.C. Memo 2004-160, aff'd 433 F. 3d 1044 (8th Cir. 2006)

⁵ *Estate of Jones v. Comr.*, 116 T.C. No. 11 (2001)

⁶ *Gross v. Comr.*, T.C. Memo 2008-221

⁷ *Holman v. Comr.*, 130 T.C. No. 12 (2008)

based on that I just did some back math to figure out how much money to put into the LLC.”

3. Interdependence test - Each of the three steps were related for legal reasons (tax planning) and would not have been pursued alone.

Litchfield v. IRS, T.C. Memo. 2009-21. Filed January 29, 2009.

The decedent was a minority shareholder in two family holding companies formed in the 1920s, one (LRC) with Iowa farmland and marketable securities and the other (LSC) with marketable securities. Both companies were incorporated as C corps and had unrealized capital gains tax liability on the potential sale of substantially appreciated assets.

Valuation experts for the estate and IRS deducted discounts for built-in capital gains taxes, lack of control (minority interest) and lack of marketability, as follows:

	LRC		LSC	
	<i>Estate</i>	<i>IRS</i>	<i>Estate</i>	<i>IRS</i>
Capital Gains Taxes	17.4%	2.0%	23.6%	8.0%
Lack of Control	14.8%	10.0%	11.9%	5.0%
Lack of Marketability	36.0%	18.0%	29.7%	10.0%

The Court agreed with the estate on capital gains taxes and lack of control but reduced its lack of marketability discounts to 25% (LRC) and 20% (LSC).

There are a few factors considered in Judge Swift’s opinion that deserve mention:

- ✓ Unlike recent Circuit Court decisions in *Dunn* and *Jelke*, there was no assumption of immediate liquidation of underlying assets on the valuation date in calculating potential capital gains taxes. The estate’s expert considered the history of asset sales and plans for future sales and then projected holding periods and sale dates, estimated future appreciation, calculated taxes and, finally, reduced the taxes to present value. The IRS expert failed to consider future appreciation in determining present value.
- ✓ Both experts used public guidelines (closed-end funds for marketable securities and REITs and RELPs for farmland) to support their discounts for lack of control. However, the IRS expert’s discount for LRC was improperly weighted so as not to reflect the fact that farmland represented two-thirds of net asset value.
- ✓ Relative “investor rights” in LRC and LSC were measured by the estate’s expert as part of his discount for lack of control analysis. For example, the inability of a minority investor to do much about LRC’s low historical returns (only 1% for farmland) helped support a larger discount for LRC than for LSC.
- ✓ The Court’s explanation for reducing the discounts for lack of marketability was brief. It said the discounts were “too high” when combined with discounts for lack of control. It also noted that the estate’s expert had used a lower discount in a previous gift tax return and had relied upon “outdated data” for restricted stock discounts.

COMMENT: In the context of the lack of marketability of an interest in a closely held family business, older restricted stock studies reflecting longer Rule 144 holding periods are actually more relevant than more recent studies with shorter holding periods.

**Gross v. Commissioner, T.C. Memo. 2008-221.
Filed September 29, 2008.**

After discussions and agreement with her two daughters about the need for a family limited partnership for investment management purposes, Bianca Gross filed a certificate of limited partnership with the State of New York on July 15, 1998. Transfers of marketable securities and nominal cash to a partnership account over the next few months were completed by December 4, 1998. One December 15, 1998 Ms. Gross and her daughters signed the partnership agreement and Ms. Gross made 22.25% gifts of limited partnership interests to each daughter. A 35% combined valuation discount was applied in valuing the gifts.

The IRS argued that indirect gifts of marketable securities had been made because the partnership was not formed until the agreement was signed, which was after the transfers.

Judge Halpern ruled in favor of Ms. Gross. The filing of a certificate of limited partnership is conclusive evidence of the formation of the partnership under New York law. Furthermore, New York law permits formation of a general partnership where limited partnership formation requirements fail if the conduct of the parties suggests a partnership arrangement. The judge reviewed the facts and found nothing inconsistent with a limited or general partnership's formation on July 15.

COMMENT: MPI was valuation expert for Ms. Gross. Our combined discount was approximately 41%. A combined discount of 35% was stipulated by the IRS and Ms. Gross.

Bergquist v. Commissioner, 131 T.C. No 2. Filed July 22, 2008.

This is an income tax case where stock in a medical practice group was given to a tax-exempt entity. The stock's value was higher if a going concern valuation approach was used rather than an asset-based approach. The IRS used the latter approach and prevailed. Most importantly, the Court accepted IRS discounts of 35% minority interest and 45% lack of marketability.

COMMENT: Restricted stock studies were used by the IRS to support its discount for lack of marketability, just as taxpayers used such studies in the *Peracchio*, *Lappo* and *Holman* gift tax cases. It is interesting to compare the results:

<i>Bergquist</i>	45%
<i>Peracchio</i>	25%
<i>Lappo</i>	24%
<i>Holman</i>	12.5%

Holman v. Commissioner, 130 T.C. No. 12. Filed May 28, 2008.

In a reviewed opinion in a case involving gifts of limited partnership interests within a few days after the partnership was formed and funded, the Tax Court rejected IRS “indirect gift” and “step transaction” arguments but said transfer restrictions in the partnership agreement should be ignored for valuation purposes, relying on Code Section 2703. In doing so, we believe the Court did not follow hypothetical willing buyer-willing seller standard precedent (see *Morrissey* and *Simplot* cases) when it speculated that a partner who wanted out would be accommodated. We understand many in the legal community view this as reversible error. In fact, the taxpayer has appealed.

MPI was the taxpayer’s valuation expert. Our combined valuation discount of 44% (14% minority interest and 35% lack of marketability) for the 1999 gifts was reduced to 22% (11% and 12.5%).

Under Section 2703 a restriction on transfer is disregarded unless (1) it is a bona fide business arrangement, (2) it is not a device to transfer property to the family for less than adequate consideration and (3) its terms are comparable to similar arrangements between persons in an arm’s length transaction. The Court did not rule on the third requirement because it decided the transfer restrictions in the partnership agreement failed to meet the first two. It saw no “bona fide business purpose” where the primary reason for the partnership was preservation of family wealth. As for the second requirement’s “device” test, the Court stated:

“...given the significant minority interest and marketability discounts from an LP unit’s proportional share of the partnership’s NAV that each expert would apply in valuing the gifts, it would appear to be in the economic interest of both any limited partner not under the economic necessity to do so but wishing to make an impermissible assignment of LP units and the remaining partners to strike a deal at some price between the discounted value of the unit and the dollar value of the units’ proportional share of the partnership’s NAV. The wishing-to-assign partner would get more than she would get in the admittedly “thin” market for private transactions, and the dollar value of each remaining partner’s share of the partnership’s NAV would increase.”

COMMENT: There is considerable discussion in the opinion about the discount for lack of marketability, its components and restricted stock studies, but the bottom line is the application of Section 2703 and its huge impact on the Court’s valuation conclusions. Indeed, even the IRS appraiser was at a 35% combined discount (11% and 27%) if the restrictions were taken into account.

Astleford v. Commissioner, T.C. Memo. 2008-128. Filed May 5, 2008.

This gift tax case involved the valuation of limited partnership interests in a family real estate partnership, one of the assets of which was a 50% general partnership interest in a partnership owning Minnesota farmland. The 50% interest was noncontrolling since each 50% general partner could not act alone.

The IRS has often argued that valuation discounts at levels below the top tier or “parent” entity are not appropriate. Here the Court allowed lack of control and marketability discounts at

both levels, noting that the farmland partnership was only 16% of overall net asset value and one of fifteen real estate investments. Concluded combined discounts were 30% for the general partnership interest and roughly 35% for the limited partnership interest.

COMMENT: Judge Swift's list of favorable multi-tiered discount Tax Court cases is handy:

Estate of Piper v. Comm'r., 72 T.C. 1062 (1979).

Janda v. Comm'r., T.C. Memo. 2001-24.

Gow v. Comm'r., T.C. Memo. 2000-93, affd. 19 Fed. Appx. 90 (4th Cir. 2001).

Gallum v. Comm'r., T.C. Memo. 1974-284.

Estate of Mirowski v. Commissioner, T.C. Memo. 2008-74. Filed March 26, 2008.

Anna Mirowski formed and funded a Maryland LLC with 90% of her assets, made gifts of 16% noncontrolling interests to her three daughters' trusts, keeping a 52% majority interest as general manager, and then died. All of this occurred over a two week period. Are these facts bad enough for Code Sections 2036 and 2038 to apply? Here are some of the reasons why Judge Chiechi rejected IRS arguments that the LLC's assets should be added back to the gross estate:

- ✓ Mrs. Mirowski's eight month illness was treatable and her death was unexpected. The entire process of finalizing LLC arrangements took a little over a year.
- ✓ Among the "legitimate and significant" nontax purposes for creating the LLC were joint management of family assets, single pooling of assets to allow for more investment opportunities, and enabling children and eventually grandchildren to share family assets equally.
- ✓ Mrs. Mirowski retained sufficient assets (\$7.5 million) to live on after her transfers to the LLC. An \$11.8 million gift tax bill would have been paid from a combination of several sources, including personal assets, future 52% LLC distributions, and /or borrowing against same.
- ✓ The LLC was found to be a "valid functioning business operation" that had to manage matters relating to patents and a license agreement for an implantable defibrillator (the "ICD", invented by Mrs. Mirowski's deceased husband) as well as a \$62 million securities portfolio.
- ✓ IRS arguments under 2036(a)(1), 2036 (a)(2) and 2038(a)(1) (retention and control of enjoyment) failed because a close reading of the LLC agreement showed that Mrs. Mirowski did not really have the authority to decide timing and amounts of distributions despite her majority interest. Furthermore, Maryland law imposed upon her fiduciary duties to other LLC members.



MANAGEMENT
PLANNING, INC.

- Corporate Valuation
- Financial Reporting Valuation
- Investment Banking
- Litigation and Expert Testimony
- Tax-Based Valuation

Princeton Headquarters : 101 Poor Farm Road, Princeton, NJ 08540 • 609.924.4200 • 609.924.4573 Fax • www.mpival.com

Atlanta, GA: 3400 Peachtree Road NE, Suite 1015, Atlanta, GA 30326 • 678.954.1120 • 678.954.1121 Fax

Boston, MA: 77 Franklin Street, Suite 512, Boston, MA 02110 • 617.482.6462 • 617.482.2515 Fax

Chicago, IL: 70 West Madison Street, Suite 1400, Chicago, IL 60602 • 312.214.6141 • 312.214.3110 Fax

Cleveland, OH: 1422 Euclid Avenue, Suite 545, Cleveland, OH 44115 • 216.861.1555 • 216.696.3944 Fax

Hartford, CT: 10 Station Street, Suite 3, Simsbury, CT 06070 • 860.651.8185 • 860.651.0032 Fax

New York, NY: 300 Park Avenue, Suite 1700, New York, NY 10022 • 212.935.4422 • 212.572.6499 Fax

Orlando, FL: 5401 S. Kirkman Road, Suite 310, Orlando, FL 32819 • 407.599.0060 • 407.641.8778 Fax



MANAGEMENT
PLANNING, INC.

101 Poor Farm Road
Princeton, NJ 08540