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Mel H. Abraham, CPA,CVA, ABV, ASA
543 Country Club Drive, Suite B-543
Wood Ranch, CA 93065
805.578.1515•805.293.8950 Fax
mel@melabraham.com

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STAY OUT OF THE FRYING PAN!

ENTITY VALUATION ISSUES & CASE LAW UPDATE

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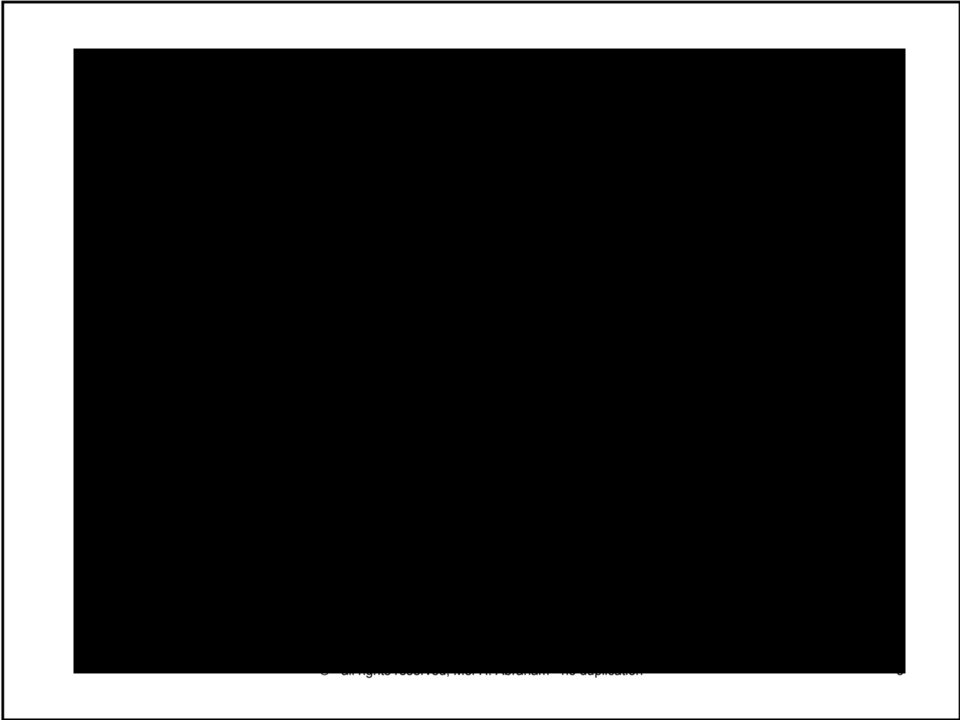

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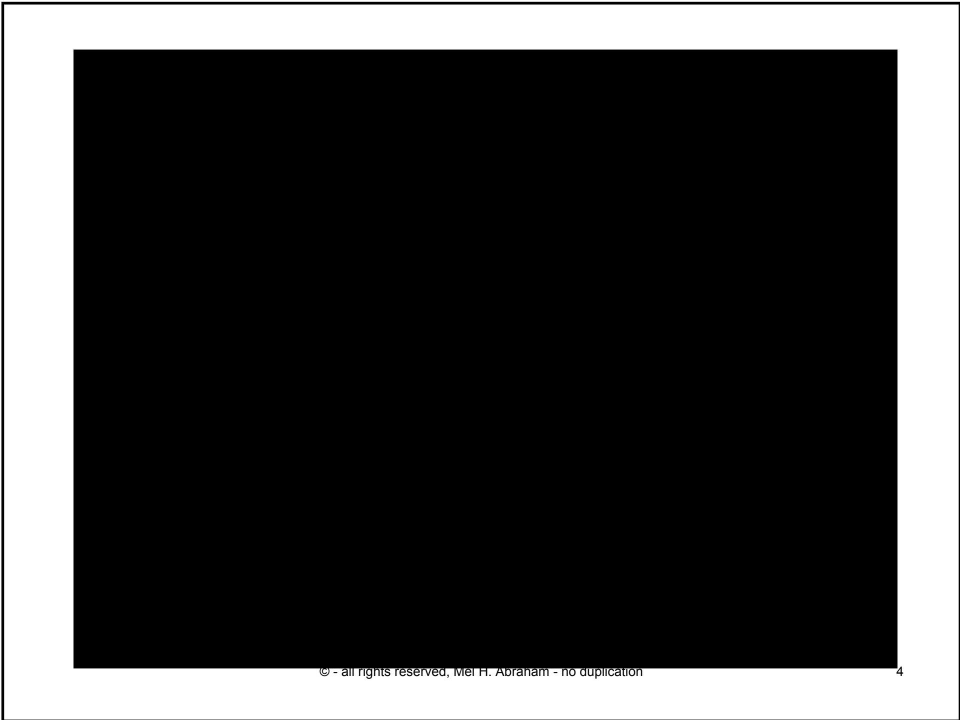

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Determining Value ...

- **Fair Market Value (Gift Tax Regulation 25.2512-1, Estate Tax Regulation 20.2031-1(b) and Revenue Ruling 59-60, 1959-1 C.B. 237) as:**

The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both having reasonable knowledge of the relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

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Four Questions ...

- For what purpose?
- Value of what?
- Value to whom?
- As of what date?

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How Does This Impact Our Work????

W.W. Jones vs. Commissioner – March 6, 2001, 116 TC No. 11

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W.W. Jones vs. Commissioner – March 6, 2001, 116 TC No. 11

- ❖During his lifetime the donor acquired several large ranches of primarily arid brushland and commercial use, cattle raising and hunting
- ❖To keep the ranches in the family the donor formed two FLPs on January 1, 1995

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W.W. Jones vs. Commissioner – March 6, 2001, 116 TC No. 11

- ❖The donor formed with JBLP one ranch property for a 95.5389% LP interest
- ❖All of the contribution was credited to his capital account

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W.W. Jones vs. Commissioner – March 6, 2001, 116 TC No. 11

- ❖ On the same day the donor transferred an 83.08% interest to his son
- ❖ His remaining interest was 12.4589%

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W.W. Jones vs. Commissioner – March 6, 2001, 116 TC No. 11

- ❖ The donor formed AVLP with the transfer of the other ranch property for an 88.178% interest
- ❖ The children contributed other property in return for limited and general partner interests

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W.W. Jones vs. Commissioner – March 6, 2001, 116 TC No. 11

- ❖The same day donor transferred a 16.915% interest to each of his 4 daughters
- ❖His remaining interest was 20.518%

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W.W. Jones vs. Commissioner – March 6, 2001, 116 TC No. 11

- ❖The interests were determined to be limited partnership interests and not assignee interests
- ❖The court denied the application of a discount for trapped-in tax if no 754 election was made

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W.W. Jones vs. Commissioner – March 6, 2001, 116 TC No. 11

- ❖Respondent's expert opined that no minority discount was applicable for the JBLP gift of 83.08%
- ❖This was because greater than 50% could compel the liquidation or sale of the property
- ❖The interest could also remove the GP

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W.W. Jones vs. Commissioner – March 6, 2001, 116 TC No. 11

- ❖The courts allowed only a 8% discount for marketability (consistent with AVLP)
- ❖The court allowed discounts of 40% and 8% on the AVLP interests

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NEWEST - HOT ITEMS!!

- ***Blount v. Commissioner – T.C. Memo 2004-116, May 12, 2004***
  - ***Ignored buy/sell under IRC §2703***
  - ***Included insurance proceeds***
  - ***Excluded ESOP Repurchase liability***

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Blount v. Commissioner – T.C. Memo 2004-116, May 12, 2004

- ***Ignored buy/sell under IRC §2703***
- ***Included insurance proceeds***
- ***Excluded ESOP Repurchase liability***

- ***Modified 1981 buy/sell agreement in 1996***
- ***Old agreement controlling for all purposes***

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Blount v. Commissioner – T.C. Memo 2004-116, May 12, 2004

- ***ESOP was created in 1992***
- ***Prior death company redeemed stock under 1981 agreement***
- ***1996 modification was signed by decedent as shareholder & on behalf of company (no ESOP signatory)***

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Blount v. Commissioner – T.C. Memo 2004-116, May 12, 2004

- ***Redemption at $4.0 million (ESOP Value = $8.5 million before other assets)***
- ***Court determined that decedent could unilaterally modify the agreement***
- ***Failed to satisfy §2703(b)(3)***

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Blount v. Commissioner – T.C. Memo 2004-116, May 12, 2004

- ***Court noted "…We do not doubt that a corporation's redemption might well occur at an arms-length price below FMV, the failure of proof leaves us to only speculate as to what that price would be…" [paraphrased]***

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Blount v. Commissioner – T.C. Memo 2004-116, May 12, 2004

- ***ESOP liquidation obligation not considered***
- ***Insurance proceeds considered an increase in FMV***
  - ***Redemption obligation not considered an offset***
- ***Improper application of transaction databases***
- ***Watch out for using outdated literature!***

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Kimbell v. U.S., 5th Circuit, May 20, 2004

- ***5th Circuit vacated & remanded Texas District Court decision***
  - ***Deemed bona fide sale***
  - ***For full & adequate consideration***
  - ***Not includable in gross estate under IRC §2036***
- ***Original District Court case stated the value of the assets includable in gross estate under IRC §2036***

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Kimbell v. U.S., 5th Circuit, May 20, 2004

- ***January 1998 - LLC (GP) and FLP formed***
- ***LLC – formed for $40,000 cash (50% decedent, 25% son & wife each)***
- ***FLP – formed for $2.5 million (cash, oil & gas working interest, securities & royalty interests) for 99% LP interest to decedent***
- ***Decedent retained $450,000 outside of FLP***

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Kimbell v. U.S., 5th Circuit, May 20, 2004

- ***FLP agreement states, "…70% LP interests could remove GP…" and GP owed NO fiduciary duty to the PS or LP holders***
- ***49% discount for lack of control & marketability taken by the estate***
- ***Key consideration under IRC §2036 – "…bona fide sale for full and adequate consideration…"***

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Kimbell v. U.S., 5th Circuit, May 20, 2004

- ***5th Circuit noted that "willing buyer-willing seller" standard of FMV is different from "adequate and full consideration" under IRC §2036(a)***

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Kimbell v. U.S., 5th Circuit, May 20, 2004

- ***Two part test –***
  - ***Bona fide sale – arm's length transaction***
  - ***Adequate and full consideration***
- ***Service stated –***
  - ***could not be arm's length due to related party – court***
  - ***Not adequate and full consideration due to discounts***

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Kimbell v. U.S., 5th Circuit, May 20, 2004

- ***"…tax planning motives do not prevent a sale from being "bona fide" if the transaction is otherwise real, actual or genuine…"***
- ***"…the business decision to exchange cash & other assets for a transfer-restricted, non-managerial interest in an LP involve other financial considerations than the ability to immediately sell it for 100 cents on the dollar…"***

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Kimbell v. U.S., 5th Circuit, May 20, 2004

- ***"…there is nothing wrong with acknowledging that the investor's $ acquired an LP interest at arm's length for full and adequate consideration and on the other hand the FMV of the asset acquired is substantially less than the $ just paid – a classic informed trade-off…"***

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Kimbell v. U.S., 5th Circuit, May 20, 2004

- ***Issue is –***
  - ***Proportionate and proper crediting of assets transferred to partner's accounts***
  - ***Substantial business and other non-tax purposes***
- ***Still waiting for determination on Assignee vs. LP interest and Strangi appeal***

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Thompson v. U.S., 3rd Circuit, September 1, 2004

- Decedent died on May 15, 1995, at the age of 97
- In 1993, he had formed 2 FLPs using the "Fortress Plan."
- Transferred substantially all of his investment assets (primarily cash, marketable securities, and loans receivable from family

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Thompson v. U.S., 3rd Circuit, September 1, 2004

- Decedent and his children agreed that Mr. Thompson would be taken care of financially.
- The Tax Court concluded that §2036(a) should apply.
- 3rd Circuit affirmed the decision completely contrary to Kimbell (5th Circuit)

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NEWEST - HOT ITEMS!!

- ***Peracchio v. Commissioner***
  TC Memo 2003-280 – 9/25/03
  - ***Lack of support for DLOM***
  - ***Use of closed-end funds***
  - ***Support for selection & valuation choices***
- ***Lappo v. Commissioner***
  TC Memo 2003-258 – 9/3/03
  - ***Use of REITs***
  - ***Bajaj Study***

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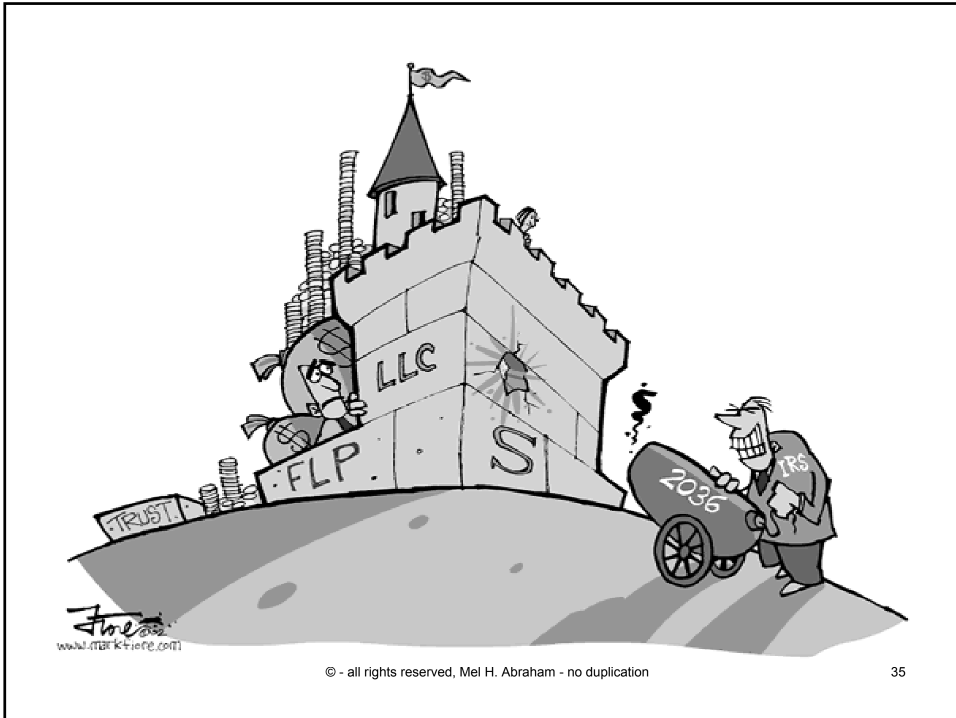

Estate of Stone – 11/7/03
T. C. Memo 2003-309

Big Win under 2036 (a)(1)!!!

The court considered the following:

1. each member of the Stone family had his own counsel;
2. each member had input into how the partnerships were to be structured, operated and funded;
3. everyone understood that Mr. and Mrs. Stone would not be bound by any agreement that their children might reach in their negotiations and that Mr. and Mrs. Stone could decide what assets they wished to transfer to the partnerships;

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Estate of Stone – 11/7/03
T. C. Memo 2003-309

4. Mr. and Mrs. Stone retained sufficient assets from the partnerships to maintain their accustomed standard of living;
5. Mr. and Mrs. Stone did not accept the children's recommendations regarding the partnerships without thought, comment, or question.
6. Found that the transfers were motivated primarily by investment and business concerns.
7. Judge Chiechi blew out the IRS contention that a transfer could not be for full and adequate consideration where the value of the partnership interest received was less than the value of the property transferred to the partnership

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Hillgren - T.C. Memo. 2004-46
March 3, 2004

- Bad facts case under §2036
- Commingling of assets
- Late filing of partnership certificate
- Distributions only to Decedent
- Tax Court disregarded partnership under §2036

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Hillgren - T.C. Memo. 2004-46 March 3, 2004

- BLA existed between sister & brother
- Substantially encumbering the properties
- IRS Expert instructed to disregard BLA
- Combined discounts allowed of 50%, 35%, 35% & 40% on 4 properties
- 5% lack of voting was also allowed

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Abraham – TC Memo 2004-39, February 18, 2004

- Another §2036 case with a twist
- 3 limited partnerships
- MA Probate Court authorized guardianship
- Gave right to income to satisfy medical, support and maintenance needs.
- "implied agreement" found through court arrangement and children's testimony
- Last Item – NO relation to me!

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THE VALUATION GAME

- The specific property interest as to FLPs/LLCs, "economic benefit"/ assignee interest – where it makes a difference.
- The tax advisor/appraiser partnership, but lawyer to avoid going too far!

Special issues –

1. built-in gains
2. tax effecting "S" corporations
3. QTIP non-aggregation (<u>Mellinger</u>)
4. co-tenancy versus entity discounts
5. deduction level discounts
6. value definition clauses (<u>McCord</u>)
7. "economic substance" doctrine
8. buy-sell agreements.

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THE FLP EXAM

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FLP DOCs & COOPERATION

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Charles & Mary McCord v. Commissioner, 120 TC No. 13, May 14, 2003

FLP Gift tax case:

- the successful use of FLP assignee interest gifts,
- rejection of a defined value or formula clause while at the same time suggesting a type of clause that could be respected,
- confusion over the date of transfer valuation principle, and, finally,
- an extensive, detailed analysis of the fair market value of the gifted assignee (economic benefit) interests in the partnership

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Charles & Mary McCord v. Commissioner, 120 TC No. 13, May 14, 2003

- ✓ FLP created in 1995.
- ✓ under formula clause agreement transferred assignee interests
- ✓ after first gifting their Class A limited partnership interests to School Foundation.
- ✓ formula clause provided trusts receive the portion of the gifted interests of FMV of $6.9 million
- ✓ the Symphony to receive portion of the excess up to & limited by $134,000, and
- ✓ the entire residue of the interests in terms of value, was specified to go to CFT.

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Charles & Mary McCord v. Commissioner, 120 TC No. 13, May 14, 2003

FINDINGS:

- o assignee interests (economic benefits only) were transferred by way of gift,
- o the aggregate FMV of the assignee interests gifted was $9.9 million (rather than the $7.4 million per the 1996 appraisal),
- o the charitable deduction for the interest allocated in the confirmation agreement to CFT was as determined by the court, and

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Charles & Mary McCord v. Commissioner, 120 TC No. 13, May 14, 2003

- petitioners' taxable gifts are to be determined without any offset for the agreed contingent 2035 contingent estate tax liability assumed by the children.
- a blended FLP asset analysis resulted in a 15% lack of control discount and
- a 20% marketability discount

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ESTATE OF STRANGI V. COMMISSIONER, T.C. MEMO. 2003-145, May 20, 2003 ("Strangi II")

FLP Estate Tax case – on remand from 5th Circuit, solely to consider IRC Sec. 2036 – and Judge Cohen, in a memo opinion did just that: 2036(a)(1) and 2036(a)(2)

- **2036(a)(1) – yes, "implied agreement" for retained control determined, so FLP failed as did valuation discounts (31% determined in "Strangi I")**
- **2036(a)(2) – in spite of alleged fiduciary duties, alternative funding of Tax Court again destroyed the FLP!**

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ESTATE OF STRANGI V. COMMISSIONER, *T.C. MEMO. 2003-145, May 20, 2003 ("Strangi II")*

- Close-to-death, power of attorney use, "package deal", no independent counsel, nearly all assets into FLP – tough facts if taxpayer trying to show this FLP had substance, other than contemplated estate tax savings.
- Strangi II only a memo opinion, plus Tax Court just filled 5 of 6 vacancies (19 total judgeships).
- Issue is clear: where do we go from here**?**

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ESTATE OF STRANGI V. COMMISSIONER, *T.C. MEMO. 2003-145, May 20, 2003 ("Strangi II")*

- *2036(a)(1) – retained control and economic benefits – including per "implied agreement or understanding"*
- *Other decisions have paved the way: Schauerhamer, Reichardt (only reviewed, TC decision), Harper, Thompson*
- *Operation of the FLP is critical – "reality is in the details"!*
- *One still open item – what is a full and adequate consideration"?*

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***ESTATE OF STRANGI V. COMMISSIONER*, T.C. MEMO. 2003-145, May 20, 2003 (“*Strangi II*”)**

- *2036(a)(2) – retained power to control who else receives benefits*
- *Byrum, 408 U.S. 125 (1972) – fiduciary duties and restraints meaningful.*
- *In Strangi II, however, Byrum distinguished, and the Strangi facts seemed to force the result of ignoring FLP – Now, what does the future hold?*

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THE 2036 AND OTHER TRAPS

Planning Options & Action Plan

A. Avoid Obvious Mistakes.

1. **Funding delays**
2. **State law compliance failure**
3. **Failure to follow FLP agreement or LLC operating agreement**
4. **“Show me the money!” (Jerry Maguire) – do not fail to make pro rata, timely distributions per plan**
5. **Watch for violation of requirements of IRC Sec. 704(e)**

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THE 2036 AND OTHER TRAPS

<u>Audit Existing FLP/LLC Plans</u>.

1. **Agreement summaries and education of client**
2. **Hold meetings, prepare minutes**
3. **Consider changes in business or investment plan – have the FLP/LLC make a difference!**
4. **If past operational or other issues, possibly liquidate (tax-free) the FLP or LLC, and "reconstitute" it in better and perhaps different fashion**
5. **Clarify and reinforce fiduciary duties of manager(s)**
6. **Set forth in agreement somewhat mandatory income distribution standards**
7. **Consider Installment Sale of manager's interest-plus former manager hopefully lives 3 years!**

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THE 2036 AND OTHER TRAPS

<u>Should an FLP/LLC Plan be Used at All</u>?

1. **The <u>Mellinger</u> QTIP non-aggregation principle where "two-life" plan**
2. **FLP/LLC setup <u>after</u> death of first spouse**
3. **Co-tenancy real estate plan**
4. **As always, keep in mind <u>opportunity shifting</u>**

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THE 2036 AND OTHER TRAPS

<u>New Entity Plan – FLPs/LLCs</u>.

1. **Use no "transfer" and/or "bona fide sale" exception in planning structure**
2. **"Form today, gift tomorrow" (e.g. 6 months later)**
3. **Fit more within <u>Byrum</u>:**
4. **Trusts as donees, with independent trustee or "trust protector"**
5. **"unrelated party" owners**
6. **develop an "active business"**
7. **Use "layered discount" planning where possible**
8. **Fixed dollar amount to heirs, balance (if any) to private foundation**
9. **Donor not a manager – use separate business entity (ala "family office")**

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Trapped-In Tax Score Card

- Dunn v. Commissioner, U.S. Court of Appeals 5th Circuit, No. 00-60614, August 1, 2002
  - IRS argued that no discount should be allowed for the trapped-in gains
  - *Court held "…as a matter of law that the built-in gains tax liability of this particular business's assets must be considered as a dollar-for-dollar reduction when calculating the asset-based value…"*

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Dunn – Other findings

- *Commissioner merely engaged in guerilla warfare, presenting only an accounting expert to snipe at the methodology of the Estate's valuation expert.*
- *use of such trial tactics might be legitimate when merely contesting values proposed by the party opposite,*
- *but they never suffice as support for a higher value affirmatively asserted by the party*

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Dunn – Other findings

- *It can only be seen as one aimed at achieving maximum revenue at any cost,*
- *seeking to gain leverage against the taxpayer in the hope of garnering a split-the-difference settlement –*
- *or, failing that, then a compromise judgment --*

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Dunn – Other findings

- *somewhere between the value returned by the taxpayer (which, by virtue of the Commissioner's eleventh-hour deficiency notice, could not effectively be revised downward) and the unsupportedly excessive value eventually proposed by the Commissioner. And, that is precisely the result that the Commissioner obtained in the Tax Court.*

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Dunn – Other findings

- lesser the likelihood of liquidation, the greater the weight that must be assigned to the income approach.
- The Fifth Circuit determined that 85% of the final value should be determined using the income approach.
- exacerbated by the failure to adduce expert appraisal testimony in support of an exorbitant proposed value"
- The Fifth Circuit told the Tax Court to entertain any claim that the taxpayer might make under I.R.C. §7430, which awards certain costs and fees to the taxpayer.

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Jameson – Order - Judge Gale August 25, 2003

- Magnitude of adjustment unprecedented and court disagrees with methodology
- Nonetheless will apply it here
- No conceptual difference between capital gains cost and selling costs

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Thompson v. Commissioner, TC Memo 2004-174 – July 26, 2004

- NY publisher (Thomas Register)
- Hired Alaska attorney to do valuation
- Assisted by a CPA
- Both had little or no training and experience

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Thompson v. Commissioner, TC Memo 2004-174 – July 26, 2004

- 40% DLOC and 45% DLOM – no support or "credible explanation"
- IRS revised report for errors and changed DCF terminal value
- Also used market approach

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Thompson v. Commissioner, TC Memo 2004-174 – July 26, 2004

- No DLOC on DCF
- Court found both "deficient and un persuasive" and "barely qualified"
- Court found 18.5% cap rate (no growth), 15% DLOC & 30% DLOM = $13,525,240

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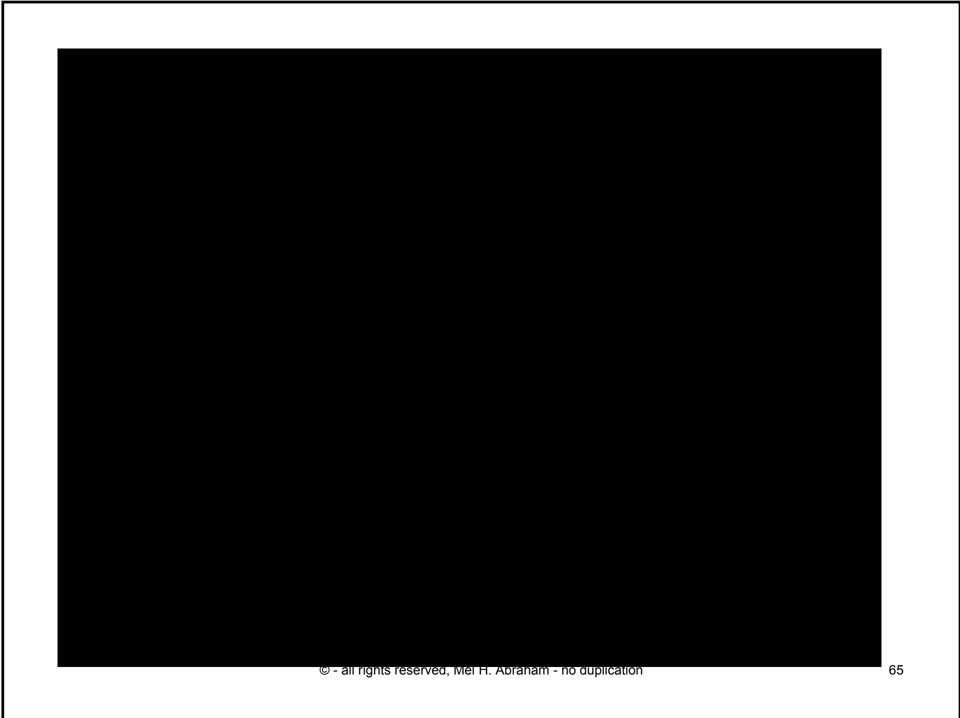

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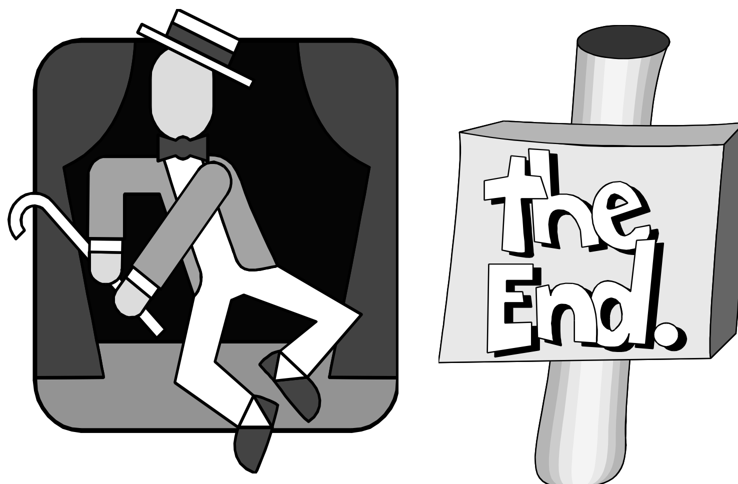

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Mel H. Abraham, CPA,CVA, ABV, ASA
543 Country Club Drive, Suite B-543
Wood Ranch, CA 93065
805.578.1515•805.293.8950 Fax
mel@melabraham.com

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