Recent Valuation Case Summaries

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<u>Litchfield v. IRS</u>, 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**	
	Estate	*IRS*	*Estate*	*IRS*
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.

<u>Gross v. Commissioner</u>, 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. On 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.

<u>Holman v. Commissioner</u>, 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.

<u>Astleford v. Commissioner</u>, 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.