ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

RPPT eREPORT

NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Articles

HECKERLING MUSINGS 2007

Highlights of Estate Planning Hot Topics and

Current Developments Discussed at 2007 Heckerling Institute on Estate Planning

By Steve Akers

This Issue's Table of Contents

The 41st Annual Philip E. Heckerling Institute on Estate Planning the week of January 8, 2007 was again outstanding. I have summarized some of my observations from the week that I want to take away from the Institute. I attribute all the good ideas to other speakers at the conference and other ideas that I have recently heard. I have not researched the various issues to confirm the correctness of or to endorse all of the ideas presented by the various speakers. The summary includes some substantive items that I personally found interesting and includes a wide variety of interesting and creative planning strategies. (I obviously could not attend all of the meetings, and doubtless there are many other highlights from the week that I have not included.) I generally have not included a number of current developments that were discussed at the Heckerling Institute but that I have previously addressed in my “Fall Musings 2006.” **Click here to continue reading this article.**

This page was printed from:
http://www.abanet.org/rppt/publications/ereport/2007/1/Heckerling.shtml

Close Window

© 2007. American Bar Association. All Rights Reserved. ABA Privacy Statement

Print This Page | Close Window

ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

RPPT eREPORT

NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Articles

IRS ISSUES RULING ON BUILT-IN LIABILITY

By Jim Roberts

This Issue's Table of Contents

In TAM 200648028, August 4, 2006, the Internal Revenue Service issued a ruling on, among other things, valuation as affected by a built-in liability. Two things are of note here. One is that the type of tax liability is different from most other cases. Secondly, the Service is intent on getting the likelihood and timing of the realization of that tax liability into the equation of value.

Here, housed under the subheading "Pension Liability," the Service recited the following reasoning:

In Estate of Jelke v. Commissioner, T.C. Memo. 2005-131, the court considered the extent to which a potential capital gain tax liability (that would be incurred only when the corporate assets were sold) was to be taken into account in determining the fair market value of an interest in a closely held corporation. The court determined that the net asset value of the corporation should be reduced to reflect the liability that would necessarily be incurred when the corporate assets were sold. The Commissioner's expert calculated the appropriate reduction based on projections of when the tax liability would likely be incurred. The court agreed with this approach, and held

that, because the tax liabilities are incurred when the property is sold, the liabilities must be indexed or discounted to account for the time value of money. See also, Estate of Dunn v. Commissioner, T.C. Memo 2000-12, rev'd, 301 F.3d 339 (5th Cir. 2002); Estate of Jameson v. Commissioner, T.C. Memo 199943, rev'd, 267 F. 3rd 366 (5th Cir. 2001). In Estate of Dunn, the Fifth Circuit concluded on this point that under an asset-based valuation methodology, the net asset valuation should be reduced for the built-in gains tax liability on a dollar-for-dollar basis and the probability of liquidation was to be considered in assigning relative weights to the asset-based and income-based valuation approaches.

*In this case, * * * Co. 1 and the corporate members of the control group may be required to pay the $ AA pension liability at some time in the future. Therefore, this potential liability should be taken into account for valuation purposes. However, a dollar-for-dollar reduction for the $ AA pension liability would not be appropriate if the payment will not be due until some time in the future. Accordingly, if, as of the valuation date, the facts indicated that the liability would not be due and payable for an extended period of time, the $ AA liability must be indexed or discounted to account for the time value of money. See also, Okerlund v. United States, 365 F.3d 1044 (Fed. Cir. 2004) (underlying valuation projections are made using facts known on the valuation date, but post-death events may demonstrate the reasonableness of those projections).*

In the cases cited, and others that stem from the *Estate of Davis* case, the courts were dealing with built-in capital gain tax liability. The courts said that a hypothetical willing buyer would take that potential liability into account. Here, however, the potential liability was an unfunded pension liability. This ruling appears to have indicated a willingness by the IRS to expand the types of taxes to be taken into account in the valuation of assets in a decedent's estate.

For the IRS, the possibility and timing of the tax liability must be taken into account in an asset-based valuation approach. That much is apparent in this ruling. The Service's position is bolstered by the *Jelke* case.*Jelke* appears to fly in the face of the *Dunn* and *Jameson* cases decided by the 5 th Circuit, which say flatly that the existence of the potential tax must be taken into account in an asset based valuation, and the possibility and timing of the tax is not to be considered. In the *Jelke* case, the Tax Court, after reviewing cases from the 2 nd, 5 th and 6 th Circuits striking down the Tax Court's determinations of improbability of triggering a tax liability or whether and to what extent it should be considered, said, "We are not bound by or compelled to follow the holdings of a Court of Appeals to which our decision is not appealable." From that the Tax Court worked out a discounted present value approach to what otherwise was an asset-based valuation.

In the 2 nd Circuit case of *Eisenberg v. Commissioner*, the court said " The issue is not what a hypothetical willing buyer plans to do with the property, but what considerations affect the fair market value of the property he considers buying." Later, the court stated, "We believe that an adjustment for potential capital gains tax liabilities should be taken into account in valuing the stock at issue in the closely held C corporation even though no liquidation or sale of the Corporation or its assets was planned at the time of the gift of the stock."

Apparently, the *Jelke* case was not appealed. Attorneys and valuation experts are left to contemplate whether and to what extent timing of a tax liability should be taken into account in

asset based valuations. In the 2 nd, 5 th and 6 th Circuits, it appears that answer is no. But elsewhere, there is still an open question.

Jim Roberts

GLAST, PHILLIPS & MURRAY, PC

2200 One Galleria Tower

13355 Noel Road, LB 48

Dallas , Texas 75240

Estate of Davis v. Commissioner, 110 T.C. 530, 552-554 (1998); *Estate of Welch v. Commissioner,* T.C. Memo. 1998-167, revd. without published opinion 208 F. 3d 213 (6th Cir. 2000); *Eisenberg v. Commissioner,* T.C. Memo. 1997-483, revd. 155 F. 3d 50 (2d Cir. 1998); *Gray v. Commissioner,* T.C. Memo. 1997-67.

Interestingly, the Service and the Courts seem torn on which way to address these issues. See *Shackleford v. U.S.*, 262 F. 3rd 1028 (9 th Cir. 2001), affirming *Estate of Thomas Shackleford v. U.S.*, 84 A.F.T.R. 2d (RIA) 5902 (E.D. Cal. 1999) which dealt with a lottery prize payable in installments on the basis of a valuation discount.

Jelke dealt with estate of a Florida decedent (11 th Circuit) holding 6.44% of a holding company which held marketable securities, where the turnover in those investments was limited, and holdings tended to be long term. In that case, the Tax Court relied on an expert who, doing an asset based approach, calculated the rate of turnover and discounted to present value the liability that would be incurred from time to time.

In *Dunn*, the 5 th Circuit left open the use of the likelihood of triggering the tax only when determining the weight to be assigned an asset-based approach in comparison to other approaches.

Eisenberg v. Commissioner, T.C. Memo. 1997-483, revd. 155 F. 3d 50 (2d Cir. 1998)

This page was printed from:
http://www.abanet.org/rppt/publications/ereport/2007/1/JimRoberts1.shtml

Close Window

© 2007. American Bar Association. All Rights Reserved. ABA Privacy Statement

Print This Page | Close Window

Articles

PROPOSED Small Business and Work Opportunity Act May Affect Expatriates

By Jim Roberts

This Issue's Table of Contents

As part of the wrangling over an increase in the minimum wage, the possibility of attaching a tax bill to the minimum wage bill is closer to reality. On January 16, 2007, the Senate Finance Committee reported out the Small Business and Work Opportunity Act. Buried in the provisions of the bill is are provisions changing the tax rules relating to expatriation to avoid tax, some of which will be of interest to estate planners.

The main body of the existing rules related to expatriation are in Section 877 of the Internal Revenue Code. Section 205(a) of the proposed legislation seeks to add a new Section 877A titled "Tax Responsibilities of Expatriation" which attempts to define who is considered an expatriate, when expatriation occurs, and the effects. Of particular note to estate planners are subsection (d)(2), which has special rules for certain retirement plans, and subsection (f), which provides special rules applicable to beneficiaries' interests in trust. On the former, the assets are treated as distributed, which would trigger immediate recognition of ordinary income. In the case of the

latter, the beneficiary's interest in the trust is treated as a separate share which is liquidated and distributed. In both cases, additional rules are provided for when distributions actually occur.

Also of interest is section (b) of Section 205 which amends Section 102 of the Internal Revenue Code, which otherwise makes receipts of gifts and inheritances not subject to income tax. If the new statute is passed, transfers from a covered expatriate will be subject to income tax. The carry-over basis rules will not apply, giving the donee a basis equal to the asset's fair market value.

While these provisions are not yet law, they bear watching.

Jim Roberts

GLAST, PHILLIPS & MURRAY, PC

2200 One Galleria Tower

13355 Noel Road, LB 48

Dallas , Texas 75240

The text of the act is available at
http://www.senate.gov/~finance/press/Bpress/2007press/prb012207legb.pdf

At the foregoing link, the new proposed Section 877A starts at page 50.

At the foregoing link, the proposed amendment to Section 102 starts at page 73.

This page was printed from:
http://www.abanet.org/rppt/publications/ereport/2007/1/JimRoberts2.shtml

Close Window

© 2007. American Bar Association. All Rights Reserved. ABA Privacy Statement

Print This Page | Close Window

ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

RPPT *e*REPORT

NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Articles

IRS ISSUES GUIDELINES ON TREATMENT OF FLPs AND FLLCs

By Jim Roberts

This Issue's Table of Contents

IRS ISSUES GUIDELINES ON TREATMENT OF FLPs AND FLLCs

In October of 2006, the Internal Revenue Service released its “Appeals Coordinated Settlement Guidelines” for dealing with family limited partnerships and family limited liability companies. In the opening lines, the Service identifies four issues, as follows:

1. Whether the fair market value of transfers of family limited partnership or corporation interests, by death or gift, is properly discounted from the pro rata value of the underlying assets.

2. Whether the fair market value at date of death of I.R.C. §§ 2036 or 2038 transfers should be included in the gross estate.

3. Whether there is an indirect gift of the underlying assets, rather than the family limited partnership interests, where the transfers of assets to the family limited partnership (funding) occurred either before, at the same time, or after the gifts of the limited partnership interests were made to family members.

4. Whether an accuracy-related penalty under I.R.C. § 6662 is applicable to any portion of the deficiency.

After a brief review of the background on FLPs and FLLCs, the Service says, "Thus, the IRS generally considers two basic issues with family limited partnerships: the validity issue (often known as the IRC § 2036 and § 2038 issue) and the valuation issue. The issue of indirect-type gifts, where the transfers of family limited partnership interests are made before, at the same time as funding, or shortly thereafter, is also raised where facts and circumstances support it."

What follows are four sections, each addressing the four numbered issues quoted above. Each section begins with a summary of the IRS's position and what the Service views as the taxpayers' argument. Two things are noteworthy ab out the IRS' analysis. One is that a brief examination of the sections reveals that cases which have gone against the Service may not be mentioned or are dismissed, and that should reveal to the practitioner a possible point of discussion when dealing with an audit. A second point is the lack of depth in the analysis.

On the first of those two obser vations, and by way of example, in the first section dealing with valuation discounts, noticeably absent is any mention of the *Dailey*case in which the Tax Court gave a 40% discount on an FLP holding marketable securities. And the Service takes pains to refer to the "recent" case of *Kelly* wherein the Tax Court gave a 32% discount for a FLP holding nothing but cash and certificates of deposit, saying the case is an "anomaly … and should not be considered valuable guidance."

The Service's guidance is also noteworthy in its lack of depth, presumably absent so that personnel who are not estate tax attorneys can have some grasp of the concepts. For example, in the section dealing with Section 2036(a), the Service's guidance on Harper is limited to: "In ***Estate of Harper,*** the taxpayer commingled personal funds, delayed in transferring funds to the partnership, and made disproportionate distributions to the donor. The Tax Court held that the amount of the transfers was includible in the estate under § 2036(a)." Harper was a 75 page long decision. While that summary is correct in one sense, it is incomplete and even misleading in its lack of any detail ab out the extensive analysis of the Court. In its decision, the Court went through a detailed examination of the partnership agreement to lay the foundation for some parts of the rest of its decision. The court carefully looked at the alleged commingling, how long the delay was in funding and why it occurred, "post-mortem accounting manipulations," indifference to the formalities of the partnership, linkage of distributions to the decedent's personal needs, the analysis of fiduciary obligations of the partners to each other and the court's view that they were breached or ignored, and numerous other points. With out this detail, it would be easy to create a three item checklist from the Service's short summary, and from that create unwarranted difficulty for an estate's personal representative.

Jim Roberts

GLAST, PHILLIPS & MURRAY, PC

2200 One Galleria Tower

13355 Noel Road, LB 48

Dallas , Texas 75240

The text of the guidelines may be viewed at http://www.irs.gov/pub/irs-utl/asg_penalties_family_limited_pships_finalredacted10_20_06.pdf

Estate of Dailey v. Commissioner, 82 T.C.M. (CCH) 710 (2001).

Kelly v. Commissioner, T.C. Memo 2005-235 (2005).

Estate of Harper v. Commissioner, 83 T.C.M. (CCH) 1641 (2002)

This page was printed from:
http://www.abanet.org/rppt/publications/ereport/2007/1/JimRoberts3.shtml

Close Window

© 2007. American Bar Association. All Rights Reserved. ABA Privacy Statement

Article

Estate of Amlie v. Comm'r : more on the comparability requirement under I.R.C. §2703

By Stevie Casteel
King & Spalding LLP

This Issue's Table of Contents

In Estate of Amlie v. Comm'r, T.C.Memo 2006-76 (April 17, 2006), the Tax Court held that a family settlement agreement entered into in 1995 would be respected under I.R.C. §2703 to establish the price of the decedent's closely-held stock for estate tax purposes. This case is important in that, not only does it expressly acknowledge that the comparability requirement under I.R.C. §2703 is a new one, but it also offers needed guidance on how comparability may be shown, which may be easier than thought after Blount.

Facts.

The decedent's will included a specific bequest of her farm land to two of her three children and a

portion of her bank stock in trust for her third child, Rod. The bequest for Rod was such amount as would equal one-half of the value of the farm land. The residue of decedent's estate was left to her three children in equal shares, with Rod's share in trust. Rod and his family also were given the first right to purchase the residual balance of the bank stock passing to the other two children.

Realizing she was having difficulty managing her financial affairs, decedent subsequently filed a voluntary petition for appointment of a conservator. After the initial conservator resigned, Boatmen's Bank of Iowa, N.A. became conservator for the remainder of decedent's life. During the conservatorship, decedent's prospective heirs had several acrimonious disputes with respect to her assets, which in the conservator's view, were highly contentious in light of the amounts involved.

When her conservator was appointed, the decedent's assets included 9,046 common shares and 13, 377 preferred shares of Agri-Bank Corp. (Agri-Bank). Decedent's common shares constituted 13.6% of the common stock of Agri-Bank. David Hill was the controlling shareholder, owning 73.2% of the common stock, and president of Agri-Bank. In 1991, Mr. Hill formed Agri Bancorporation (Agri). Agri offered to exchange one share each of Agri common stock and Agri preferred stock for each share of common stock held by Agri-Bank shareholders other than Mr. Hill. In addition, Agri and Mr. Hill sought an agreement for the eventual sale of the Agri stock that decedent would obtain in the exchange.

In 1991, decedent's conservator exchanged the decedent's Agri-Bank common stock for 9,046 shares of Agri common stock and 9,046 shares of Agri preferred stock, and entered into an agreement with Agri and Mr. Hill (1991 Agreement). The 1991 Agreement's purpose was to restrict the transferability of decedent's shares, provide for their purchase by Agri upon certain conditions, including decedent's death, and ensure that, in the event a controlling interest in Agri were sold, decedent would receive the same consideration per share for her minority interest as Mr. Hill received for the sale of his controlling interest (Hill Rights). One of the conservator's principal considerations in negotiating the 1991 Agreement was to provide for a sale of decedent's stock only after her death, when the stock would receive a step-up in basis to fair market value. Also, by securing a purchaser and a price for the stock, the conservator secured, not only a hedge against the risk decedent bore in holding a minority interest in a closely held bank, but also liquidity for estate tax. Concluding that the 1991 Agreement was in decedent's best interest, the Humboldt County District Court approved the conservator's application to enter into it.

In 1994, Mr. Hill agreed to sell his controlling interest in Agri to FABG. Mr. Hill received book value for his Agri shares in addition to several other forms of consideration. Under the terms of the merger, the minority shareholders could either redeem their shares for book value or exchange their shares for common shares of FABG. The conservator exchanged decedent's Agri common stock for FABG common stock and negotiated an agreement, pursuant to FABG's obligations under the 1991 Agreement, (the 1994 Agreement) for the post-death sale of decedent's FABG stock for 1.25 times book value, or $118.23 per share plus interest until decedent's date of death ($118 price). The $118 price was intended to compensate for the value of the stock, as augmented by the Hill Rights.

The conservator obtained advice from a valuation specialist in connection with the negotiation resulting in the $118 price. The valuation specialist reviewed "merger multiples" for other Iowa and Midwest region commercial bank mergers or acquisitions. The specialist concluded that book value was the appropriate price but, taking into account the Hill Rights, Mr. Hill had effectively received 1.33 times book value for his shares. The specialist concluded, however, that a part of Mr. Hill's additional consideration, an option to exchange his FABG stock for stock in FACC, an operating loan subsidiary of FABG in five years (Hill Option), had no value, because of the multiple variables that might affect relative values over the five year period. Accordingly, the specialist found the $118 price, coupled with the right to defer the sale to avoid capital gains tax, constituted a fair price.

But when the conservator sought court approval to enter into the 1994 Agreement, decedent's son, Rod, filed formal objections in which he claimed that the $118 price failed to properly value the Hill Option. At a hearing at which conflicting expert testimony was heard, FABG testified that a rejection of the 1994 Agreement would lead to further litigation, that decedent would not be offered a Hill Option, and that FABG would take the position that it was entitled, as Agri's successor, to purchase decedent's stock only for book value pursuant to the 1991 Agreement. The district court declined to approve the 1994 Agreement.

The conservator, based on its belief that further litigation over the 1991 Agreement and 1994 Agreement was not in the decedent's best interest, commenced negotiations with the prospective heirs to obtain agreement on a price at which decedent's FABG stock could be sold. The conservator believed it was potentially a violation of its fiduciary duties to continue to hold a substantial portion of decedent's assets in the form of a minority interest in a closely hold bank, and that the deferred sale arrangement in the 1994 Agreement was a significant benefit by virtue of the capital gains tax savings, which would be lost if FABG were able to successfully purchase the stock under the 1991 Agreement. Similarly, the prospective heirs other than Rod preferred a guaranteed "floor" price for the FABG stock rather than risk further negotiation and litigation. Rod continued to be unwilling to accept a sale based on the $118 price.

The parties' negotiations culminated in a Family Settlement Agreement executed in 1995 (1995 FSA). The 1995 FSA required that all bequests to Rod's trust under the will be satisfied "in kind" with FABG stock, valued at the $118 price. Any FABG stock remaining in decedent's estate would be subject to reciprocal put/call options for a designated post-death period during which decedent's executor could require Rod's family to purchase the stock, or Rod's family could require the estate to sell the stock to it, at the $118 price. Finally, the Hill Rights under the 1991 Agreement were assigned to Rod and his family. The district court approved the 1995 FSA.

In 1997, Rod's family reached agreement with FABG that they would receive for the stock they received under decedent's will a price of $217.50 per share plus interest. Decedent died in 1998. Pursuant to the 1995 FSA, Rod's trust exercised its call option to purchase all of the FABG stock remaining in decedent's estate after satisfaction of the bequests of such stock to the trust. The FABG stock was sold to FABG for $1,489,724.93, the price derived under the formula in the

agreement between Rod’s family and FABG. The estate received $993,756.96, the price for the FABG stock under the formula set forth in the 1995 FSA. What the estate received was the value reported on the estate tax return.

The Internal Revenue Service issued a notice of deficiency to the estate wherein the Service determined that the value of decedent’s FABG stock was $1,489,725, its purchase price pursuant to the agreement between Rod’s family and FABG. The Service increased the taxable estate by $495,968.

Tax Court’s Analysis.

For a restrictive agreement entered into (or substantially modified) after October 8, 1990 to control value for federal estate tax purposes, the requirements set forth under I.R.C. §2703 must be satisfied. Those requisites include the requirements of preexisting case law that the agreement be a bond fide business arrangement and not be a testamentary device, and a new requirement that the terms of the agreement be comparable to those of similar arrangements entered into at arm’s length. Further, the pre-section 2703 rules requiring that the agreement be binding during life and at death, and contain a fixed and determinable price, continue to apply. The Service contended that the 1995 FSA did not meet the requirements under either pre-section 2703 rules or section 2703 rules.

The Service first argued that the agreement did not contain a fixed and determinable price because the amount of Agri stock subject to the 1995 FSA was unknowable until after the decedent died and her farm land was valued, since the amount of Rod’s specific bequest was dependent on such value. The court found, however, that under the 1995 FSA, all of the Agri stock was required to be transferred to Rod’s family’s trust at the $118 price, either in satisfaction of the specific bequest or by sale.

The Service argued next that the 1995 FSA was not enforceable because the conservator did not sign it. The court held that, although the conservator was not a signatory, it sought approval from the district court, which approved it and granted the conservator the powers necessary to effectuate the terms of the agreement. Pursuant to the terms of the 1995 FSA and the district court’s order, the court was convinced that the agreement was legally binding and that Rod’s family had an enforceable right against decedent’s estate to purchase the FABG stock at the prescribed price.

The Service then argued that the 1995 FSA did not satisfy the requirements of Section 2703.

Was the 1995 FSA a bona fide business arrangement? The court found that the 1995 FSA represented the culmination of the conservator’s efforts, starting with the 1991 Agreement, to secure a guaranteed price and buyer for the decedent’s minority interest in a closely-held bank. In

addition, the conservator secured a guarantee that, in the event the controlling interest in Agri was sold, decedent would receive the same per-share consideration for her minority interest as that controlling shareholder received. The conservator pursued the same goal after the controlling interest in Agri was sold, namely securing a fixed price from the new owner (FABG) that compensated decedent for the Hill Rights. The change in management exacerbated the conservator's concern since the decedent's minority interest in FABG was even smaller, and FABG was unfamiliar management. Finally, the court was persuaded that the decedent and/or her estate faced significant litigation hazards over the price to be paid by FABG for decedent's shares as enhanced by the Hill Rights after the district court declined to approve the 1994 Agreement. Not only did FABG possess leverage on the basis of the 1991 Agreement that could have forced the decedent to sell her shares when Mr. Hill's shares were purchased, but an official of FABG testified in the proceeding over the 1994 Agreement that if it were rejected, FABG would take the position that it was entitled, as Agri's successor, to purchase decedent's stock at book value pursuant to the call option in the 1991 Agreement. Also, further negotiation and/or litigation with FABG jeopardized the conservator's goal of avoiding capital gains tax on the sale of decedent's stock prior to her death (at the time of the 1994 Agreement proceedings, decedent was age 92). Thus, the court held that the 1995 FSA was a bona fide business arrangement.

In response to a final argument by the Service that the 1995 FSA could not meet the requirements of section 2703 because decedent's stock was an investment asset rather than an actively managed business interest, the court summarily held that hedging an investment risk, as well as planning for future liquidity needs of a decedent's estate, may serve a business purposes.

Was the 1995 FSA a testamentary device? Whether a restrictive agreement constitutes a testamentary device depends on the consideration received by the transferor judged at the time the agreement is entered into. The court found that the decedent received significant consideration under the 1995 FSA in that she received a fixed price for a minority stock interest, the value of which was otherwise uncertain and subject to substantial litigation hazards. Because the 1994 Agreement was not consummated, the decedent's net worth was exposed to risk that the conservator deemed was not prudent. The $118 price was agreed to only after the receipt of professional advice that it was a fair price. The conservator had to consider the litigation hazards of a protracted dispute with FASB, as noted above. Moreover, the court found that the agreement by the prospective heirs other than Rod to the price in the 1995 FSA was an arm's length decision. Because of their history of acrimonious disputes, the court did not believe that Rod's siblings agreed to the $118 price in order to effect a transfer to Rod for less than full and adequate consideration. Instead, they were persuaded that the security of a fixed price was preferable to the downside risk and uncertainties of continued negotiations with FABG over the appropriate value of the Hill Option.

Were the terms comparable to similar arrangements entered into by persons in an arm's length transaction? To satisfy this requirement, the estate offered the expert testimony of an attorney with extensive experience in the purchase and sale of closely held equity interests. The expert found it important that the terms of the 1995 FSA were virtually identical to those of the 1994 Agreement, which had been reached in arm's length negotiations between the conservator and FABG.

In response to the Service's argument that the regulations explicitly state that evidence of general business practice is not met by showing isolated comparables, the court held that in the context of the regulations, this "caution" delineates more of a safe harbor than an absolute requirement that multiple comparables be shown. Instead, the test requires a demonstration of the general practice of unrelated parties. In any event, the court found that the terms of the 1994 Agreement, which were incorporated into the 1995 FSA, were in fact based on a number of comparables in that the professional advice obtained to support the $118 price was based on merger multiples for mergers or acquisitions of other Iowa and Midwest region banks.

The court found other evidence that supported its conclusion that the terms of the 1995 FSA were comparable. The 1994 Agreement and the 1995 FSA (with identical price terms) were entered into by decedent's conservator, who acted under a fiduciary duty. The negotiations among decedent's prospective heirs were at arm's length in light of the fact that the interests of the heirs other than Rod were adverse to Rod's with regard to the price terms. Although the court agreed that the facts that the district court did not approve the $118 price and that Rod in fact obtained a higher price in 1997 raised questions about the adequacy of the $118 price, the court was convinced that Rod and his siblings simply disagreed about the potential risks and rewards of further negotiation or litigation with FABG over the value of the Hill Rights. Although Rod's siblings may have made a bad bargain, the court was persuaded that it was made at arm's length.

Finally, the court recognized that much contention had existed over the value of the Hill Option, but found that the value of the Hill Option was simply easier to discern over time, later in the five-year option period. Thus, the court found that the disparity between the $118 price in the 1995 FSA and the $217.50 price obtained by Rod in 1997 was attributable, at least in part, to the passage of time and the apparent appreciation of the FACC stock in relation to the FABG stock over that period and not because of any undervaluing of the stock in the 1995 FSA. This factor bolstered the court's conclusion that the terms of the 1995 FSA were comparable to similar arrangements entered into at arm's length. Again, the conservator and prospective heirs other than Rod preferred to secure an agreement in 1995 rather than risk a protracted dispute with FABG.

Impact

In summary, this case is important in two respects. First, the court expressly recognized that the comparability requirement imposed by I.R.C. §2703 is in fact a new requirement not found in pre-section 2703 law. Second, the court stated that, in satisfying this requirement, the statement in the treasury regulations that evidence of general business practice is not met by showing isolated comparables is a "caution" and a "safe harbor" rather than an absolute requirement that multiple comparables be shown. This is more lenient that the requirement appeared to be after the Blount case. In addition, we have more guidance regarding how the comparability test may be satisfied, which should help any attorney drafting or defending a buy-sell agreement under I.R.C. §2703.

This page was printed from:
http://www.abanet.org/rppt/publications/ereport/2007/1/StevieCasteel.shtml

Close Window

© 2007. American Bar Association. All Rights Reserved. ABA Privacy Statement