July 2010 – Relevant Court Decisions Involving Valuation Issues

Recent FLLC Case involving a Single Member LLC:

***Pierre v. Commissioner*, 2010 WL 1945779 (U.S. Tax Ct.)(May 13, 2010)**

Some of you may remember the Tax Court's first opinion in these proceedings. In *Pierre v. Comm'r*, 2009 WL 2591652 (Aug. 24, 2009)(*Pierre I*), the taxpayer formed a single-member family limited liability company (LLC). She then created two trusts for her son and granddaughter. Nearly two months later, she transferred $4.25 million in marketable securities into the family LLC. Twelve days after that, the taxpayer transferred her entire interest in the family LLC to the trusts, giving 50% to each trust. Her advisers later determined that she could gift a certain amount tax-free. Accordingly, the petitioner sold each trust a 40.5% membership in return for two promissory notes of $1.09 million apiece, and gifted them each a 9.5% interest. An appraiser arrived at the note amounts after valuing a 1% interest in the LLC at $26,965, including a 36.5% combined discount for lack of marketability and lack of control.

In assessing deficiencies of over $1.13 million, the IRS argued that pursuant to applicable Treasury Regulations, the entity form of a single-member LLC should be ignored for federal gift tax purposes. Accordingly, it treated the transfer of LLC interests to the children's trusts as transfers of proportionate shares of the underlying LLC assets, to be assessed at full, fair market value. In a split decision (9 to 6), the U.S. Tax Court sided with the taxpayer, despite a dissent that would have disregarded the family LLC as a separate entity when assessing federal gift tax liability.

The court postponed deciding the valuation issues, however, including the application and magnitude of the discounts. It also put off the question whether the "step transaction doctrine" would collapse the LLC and trust transfers into a single transaction. In this current opinion (*Pierre II*), the court addresses both questions.

Tax avoidance was the primary purpose. The court first examined the family LLC's operations and agreements. For instance, the LLC essentially ignored the promissory notes, having made sufficient distributions to the trusts to pay interest but receiving no principal payments in eight years. Further, although the taxpayer was the designated manager of the LLC, neither she nor her grown son actively managed the LLC or attended its sporadic meetings. In 2000, at the time of the LLC's formation and funding, an attorney/adviser prepared a single ledger to record the distribution of capital and to prepare the taxpayer's original gift tax returns. Notably, he credited each trust's capital account with 50% of the value of the taxpayer's original $4.25 million contribution and then discarded the ledger after filing the tax returns.

At trial, the attorney testified that he discarded the records because they characterized the transfers inaccurately, failing to include the four subsequent gift and sale transactions. The court was not persuaded. "We do not so easily ignore [his] contemporaneous description of the transaction," the court said. Nor would it overlook the taxpayer's "primarily tax-motivated reasons for structuring the gift transfers as she did." The four gift and sale

transactions were planned as a single transaction and took place at virtually the same time, with no independent, intervening non-tax event. The taxpayer intended not just to minimize her tax liability, the court said, "but to eliminate it entirely." Under these circumstances, including the LLC's failure to observe formal operations (failure to pay down the note, etc.), the court applied the step transaction doctrine to collapse the separate transfers into a single deal.

Given this ruling, the court valued the LLC interests not by reference to the trust's ownership but by their value in the taxpayer's hands. The parties agreed that under the fair market value standard, a willing buyer/willing seller would pay less for the LLC interests than for an outright purchase of the same block of freely traded marketable securities. To prove the applicable discounted value, the taxpayer offered the original discounted appraisal (10% for minority interest, 30% for lack of marketability [DLOM], for a combined 36.5% discount), as well as a second appraisal, prepared specifically for trial. This second expert also included a 10% minority discount, but believed a 35% DLOM was appropriate, for a cumulative 41.5% discount.

Notably, the IRS chose not to present its own expert valuation, relying instead on its original claims (in *Pierre I*), that the gifts were of the underlying assets of the LLC. Having lost that argument, in *Pierre II* the IRS simply requested the court to reduce the taxpayer's proposed discounts.

Taxpayer wins by default? Although the taxpayer's trial expert agreed with the original assessment of a 10% minority discount, he conceded that this applied to LLC interests of 40.5% and 9.5%. If he'd reviewed the rights and restrictions applicable to a 50% interest in the LLC, he would have reduced the discount to 8%, he said. Given the court's collapse of the gift and sale transactions into transfers of 50% apiece, it accepted and applied the 8% discount for lack of control.

Despite her trial expert's 35% DLOM, the taxpayer advocated for only 30%, as set forth in her original appraisal. Although the IRS argued that a 35% marketability discount was too high, it failed to contest the 30% DLOM at trial. Further, the IRS offered no evidence or expert testimony concerning the LLC interests. Based on the available evidence, presented by the taxpayer, the court held that a 30% marketability discount was appropriate and applied the same.

CVS Comment: We do not see a lot of single member LLCs in gift and estate tax planning and this case underscores one reason why!

Undivided, Fractional Interest in Personal Residence Case:

***Ludwick v. Commissioner*, T.C. Memo. 2010-104, 2010 WL 1850223 (U.S.Tax Ct.)(May 10, 2010)**

Not much was at stake in this case—at least in terms of dollars. But the U.S. Tax Court's substantial, if not sole, reliance on a weighted, cost-to-partition approach to determine the fair market value of undivided half interests in real property may have just raised the stakes for appraisers who value these assets in estate and gift tax cases. *This is the type of an engagement that CVS see all the time.*

Experts dispute discounts. A married couple owned a $7.25 million Hawaii vacation home as tenants in common. In 2004 they transferred their respective interests into qualified personal residence trusts, valued at a 30% discount for federal gift tax purposes. In assessing deficiencies, however, the IRS only permitted a 15% discount, later reduced to 11% at trial.

To determine the fair market value (under the hypothetical willing buyer/willing seller standard) of the taxpayers' undivided one-half interests in the property, the Tax Court considered the parties' expert evidence. Both experts took broadly similar approaches but predictably reached different conclusions to support their respective discounts.

The taxpayers' expert compared sales of undivided interests that took place between 1961 and 2006. He calculated the mean, median, and range discounts for all the data and three subsets: 16 income-producing properties, 26 parcels of raw land, and 22 sales of undivided half-interests. He also assessed 10 real property LP (limited partnership) transfers.

By contrast, the IRS's expert relied on only four sales of undivided interests between 2002 and 2007. He also relied on five surveys that his firm had conducted over the years. Three questioned California brokers regarding the range of discounts they'd seen in transfers of fractional interests; two asked brokers about their experience with so-called "pooled public tenancy-in-common investments" (professionally managed investment properties with multiple owners). Fractional interests in the latter investments traded with almost no discount, the expert noted.

Finally, the IRS expert relied on a study of tender offers for majority interests in public firms—in particular, transactions involving the change of control in real estate companies. "If the market price were $100 and a buyer tendered $125, then the premium would be 25% and the discount would be 20%," he explained. However, he also noted that the size of the premium would depend on many factors, such as a buyer's motives and portfolio.

Court disappointed with the data. Overall, "we do not find the analysis of either expert convincing," the court said. The taxpayers' expert provided "no way" for the court to evaluate his conclusions; he failed not only to explain how he calculated the discounts (or the underlying fair market value), but to provide "any measure of the variability or dispersion of his data points," including their standard deviations. "More importantly," the

court noted, "he did not provide any of the data; we do not know the specifics of any of the 'undivided interest transactions.' We have no way to know how comparable those properties are."

The expert's reliance on real property LP interests was similarly flawed. The taxpayers' property was a private home, never intended to produce income. "The cash flow statements of the 10 limited partnerships (which held, for instance, apartment buildings and mobile homes) are not relevant," the court concluded.

The IRS expert fared no better. His selected sales of undivided half interests all involved commercial property in the eastern U.S.; the data did not indicate the appropriate discount for a multimillion dollar home in Hawaii. Similarly, the court had "no way" to evaluate or reconcile the data in the brokers' surveys, "because we have no information about the transactions on which the brokers based their opinions." Moreover, their opinions were often "so cryptic as to reveal almost nothing about the reasons behind the discount ranges," the court said, finding the surveys provided "little guidance."

Finally, the IRS expert argued that any differences between the pooled investment data and the taxpayers' property increased the discount "only slightly," but he failed to explain how to the court's satisfaction. He also did not provide adequate support for applying the tender offer data to the discounts in this case. "We find the tender offer analysis unhelpful," the court said.

After indicating its disappointment with the expert data, the court focused on the following key question: "Why a buyer of an undivided interest in the property would consider the interest worth any less than a proportional share of the fair market value of the whole property reduced by the cost to the buyer of partition; i.e., the cost to end joint ownership involuntarily by a judicially mandated sale … and to distribute the proceeds appropriately."

Although the court conceded the buyer would consider some marketability risk, owning an undivided half-interest in real property did not necessarily mean that the buyer would apply any discount "more than the cost of liquidating his investment and an additional amount to reflect the risk occasioned by a less than immediate sale," the court observed. In other words, a buyer with a right to partition could not demand a discount greater than 1) the discount reflecting the cost and likelihood of partition; and 2) the discount representing the marketability risk. "If he did, another (rational) buyer would be willing to bid more," the court said. "That iterative process would drive the discount down to the discount reflecting the expected cost of partition and the marketability."

Taking a cost-to-partition approach. Accordingly, to determine fair market value, the court needed to determine the likelihood, length, and costs to partition the property, plus the buyer's required rate of return. The taxpayer's expert testified that a contested partition would take two to three years to resolve at a cost of $80,000 (for appraisal and legal fees). The IRS expert thought two years and up to $20,000, plus 6% to 8% brokerage fees, would take care of any disputed division. If partition were not necessary, he believed the property would sell in less than a year.

Based on this evidence, the court found that a contested partition would take two years, including one to sell the property, with costs at 1% of the property's value ($72,500). Neither expert suggested the likelihood of partition; nevertheless, the court bore heavily on the taxpayers (because they shouldered the burden of proof) to find that a buyer would expect partition 10% of the time. In this case, the cost of selling the property would be 6% of its fair market value ($435,000), plus one-half of the property's annual maintenance cost ($175,000).

Finally, the court rejected the 30% rate of return advocated by the taxpayers' expert, finding it unsupported, and adopted the 10% rate put forth by the IRS expert. It also applied his 3% long-term, annual sustainable growth rate. Applying all its inputs and assumptions, the court found the fair market value of an undivided half interest in the property to be $3.03 million if partition was not necessary and $2.67 million under a partition scenario. Given its finding that a partition would occur only 10% of the time, the court's final weighted average of the two present values was just over $3 million each fractional interest, effectively applying a discount of 17%.

CVS Comment: The going-in discount appeared rather high for this type of engagement. We usually see QPRT engagement discounts at "less than 20%" based on reasonable waiver of partition. However, in this instance it appears that the taxpayers' appraiser was not able to clearly articulate a credible (marketability) discount. The court was correct, the discount is really an impairment of marketability but then decided to analyze based on cost to partition time and expenses. Thus yielding a more conservative discount.

Indiana Family Law Case – Deliberates Fair Value & Discounts in Family Law Setting:

***Alexander v. Alexander*, 2010 WL 2006427(Ind. App.)(May 20, 2010)**

It's difficult to overturn precedent in connection with almost any longstanding legal rule. Along with the *Thornhill* case in Colorado this recent Indiana case suggests the challenge may be even greater in divorce, especially in states that give trial courts the broad discretion to effect a "fair and equitable" disposition of the assets based on the facts of the case and the parties' particular circumstances.

Discounts applied to LP interest. The Alexanders were married nearly 30 years and accumulated substantial property. In particular, the couple operated a Century 21 Realty franchise, in which the husband was the sole shareholder, and, through her family, the wife owned a 5% limited partnership interest in a company that owned and operated over 1,300 acres of prime Indiana farmland. At their divorce trial, the parties presented widely divergent expert evidence:

1. *Realty business.* The wife's expert appraised the Century 21 franchise based on an income analysis, eliminating interest expenses and increasing cash flow based on projected returns, to reach a value of $288,600. By comparison, the husband's expert found all expenses to be legitimate. Based on the company's tax returns, its negative cash flows and the downturn in the real estate market, he applied an 80% discount for an overall value of only $35,800. He conceded, however, that his discount was a subjective

determination, unsupported by any specific authority. The trial court accepted the husband's expert analysis, but reduced his 80% discount for negative cash flows to 50%, for an ultimate value of $119,475.

2. *Family farming business*. As general partners, the wife's parents retained full control over the company. Limited partners (LPs) had no power to force a partition or sell their interests without the parents' first refusal. The wife's expert applied a 25% minority discount and 15% marketability discount to her LP interest. The trial court accepted the expert's methodology, including discounts. After adjusting for an error in the expert's underlying real estate appraisal, it valued the wife's LP interest at $253,670.

The husband appealed, and the Indiana Court of Appeals quickly confirmed the value of the realty franchise, finding it fell within the range of expert opinions. It took longer to discuss the husband's arguments regarding the discounts.

The court first noted that a majority of U.S. jurisdictions have rejected minority and marketability discounts when determining the fair value of stock in statutory buyback cases, to prevent a windfall to the majority owners at the minority's expense. Similarly, given the parents' right of first refusal in this case, it was clear that—should the wife need to sell her LP interest to effectuate the distribution of marital property—the other partners would be the likely buyers. By analogy to the majority and Indiana rule on statutory fair value, the husband contended the court should preclude minority and marketability discounts in divorce.

The wife cited three Indiana divorce cases authorizing trial courts to apply discounts to business valuations in their discretion. In the first, the state Supreme Court rejected the discounts—not because they were inappropriate in divorce settings but because the parties were joint owners and "not burdened by factors which may warrant consideration of the 'minority interest' discount." (Essentially, one of the parties would accede to full ownership after divorce.) In the second case, the Indiana Court of Appeals ruled that a trial court was not required to accept an expert's application of a marketability discount; and in the third, it ratified a trial court's acceptance of a marketability discount, based on expert evidence.

Court considers 'real world' alternatives. However, none of these opinions directly considered the appropriateness of minority and marketability discounts in divorce, the court said, and conceded an "arguable connection" to the statutory fair value case law. For instance, in this case the wife would likely inherit a controlling interest in the farm partnership from her aging parents, or she would sell her 5% interest to the controlling partners at fair market value—"considerably more" than the trial court's value. (She might even sell back to her parents the day after divorce, the court noted.)

Nevertheless, "we conclude that marketability discounts and minority interest discounts can be utilized by a trial court in dissolution proceedings when determining the value of ownership interests." Unlike a court in statutory fair value cases, family courts retain broad discretion in valuing marital property, which leads to "a more direct and simple evaluation," the appellate court said. Further, unlike statutory fair value cases, the wife has no express intent to sell her LP shares. The trial court need not prevent a windfall to the other owners of the farming partnership. Rather, it need only place a value on the wife's interest "as she currently holds it."

Finally, family courts often have to value assets as they are currently held (such as pensions) and not as the benefits might be worth in the future. "Similarly, a trial court should be able to determine the present value of a spouse's ownership in light of marketability and minority shareholder discounts," the court ruled, and affirmed the discounted values in this case.

CVS Comments: We are observing more discounts being argued in family law than previously. This is a wonderful articulation of facts and circumstances carrying the day because the wife was a limited partner in a credible FLP. The Court agreed with discounting her limited partnership interest. Also the article also stated something we agree with: family law courts are environment of wide latitude!