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In this *Valuation Update* we have three cases – two are family law related and one Tax Court case:

1. *Estate of Liljestrand v. Commissioner, T.C. Memo 2011-259; November 2, 2011*: A US Tax case that deals with several problematic areas in FLP management and history in regard to IRC 2036(a) and 2036(a)(I) issues. Very interesting read.
2. *Short v. Short, 2011 WL 5057209 (Mo. App. E.D. - Oct. 25, 2011)*: Another case where appraisals are used in different engagements – this time a tax appraisal is used in a family law case.
3. *Heller v. Heller, 2011 Ohio App. LEXIS 4391 (Ohio Ct, App. Oct 18, 2011)*: *Heller v. Heller* in Ohio had three remands struggling with the issue of the “Double Dip”.

Latest ‘Bad Facts’ FLP Case Emphasizes Poor Planning, Operations ***Estate of Liljestrand v. Commissioner, T.C. Memo 2011-259; November 2, 2011***

After retiring in 1978, a doctor exchanged his interest in a Hawaiian hospital for several real property holdings, including condominiums and a shopping center in California, a warehouse in Oregon, a Florida strip mall, and a medical building in Arizona. Just about six years later, the doctor formed a revocable trust to hold the real property, naming his eldest son as trustee and also paying him to manage the property.

FLP to ensure son’s employment. By 1996, the doctor wanted to plan his estate on behalf of all his four children, but also wanted to make sure that his eldest son kept his position managing the real estate businesses, in which none of his siblings showed an interest. In addition, he was concerned that if he gifted the property while it remained in trust, then local (Hawaiian) law would allow his other children as beneficiaries to seek judicial partition of the property and oust him as manager.

To alleviate these concerns, an estate planning attorney suggested that the father form a family limited partnership (FLP), funded with the trust-owned properties. Accordingly, the attorney formed the FLP in 1997, naming the father as the 99.8% general partner and giving the son a small Class A limited partnership (LP) interest. Within six months, the father transferred all his real property investments, appraised at roughly \$6 million, to the FLP.

Over the next two years, he gifted Class B LP units to four trusts established for each of his grown children. Based on the underlying real property values, an appraisal firm valued the Class A LP units at \$2.14 million and the Class B units at \$5.91 million, as of the date of FLP formation (1997). However, according to court records, the parties “ignored” the formal appraisal. Instead, they valued the FLP’s general partnership units at \$59,000,



and its LP units at \$310,000 (Class A) and \$2.0 million (Class B). “It is unclear how the interests were valued,” the court observed.

The parties also ignored the formalities of the FLP and its operations. For instance, they continued to treat the father’s former revocable trust as owner of the real estate, depositing the operational income into the trust’s bank account until 1999, when they finally created a bank account for the FLP. The family’s accountant also reported the real estate income on the father’s personal tax returns in 1997 and 1998. After discovering her mistake, the accountant began keeping appropriate books and records for the FLP, and filed its return in 1999; but rather than go back and amend the prior returns, she decided (along with the father and his attorney) to treat the FLP as commencing operation in 1999. Similarly, the FLP did not execute a formal management agreement with the eldest son until 2001.

Since the father had contributed all but his personal residence to the FLP, the FLP made disproportionate distributions, larger than those provided by the partnership agreement, to pay his living expenses and debts as well gifts to his grandchildren. The FLP also “loaned” money to the eldest son, but he never wrote a promissory note or repaid the loans. When the father passed away in 2004, the FLP refinanced certain properties and used the proceeds to pay the father’s estate taxes of \$2.3 million.

In 2008, the IRS assessed a \$2.6 million deficiency, based on including the entire fair market value of the father’s real estate holdings in his estate pursuant to IRC Section 2036(a), and the taxpayer petitioned the court for a determination of liability.

FLP asserts three business purposes. To qualify the FLP transfers for the 2036(a)(1) exception as bona fide sales for full and adequate consideration, the estate claimed that the FLP had at least three legitimate, non-tax business purposes, and the Tax Court examined each in turn:

1. *Ensured son’s continued employment.* By preventing the conflict of interest that formerly existed when the son was acting both as trustee of the revocable trust that held the real properties and their manager, the FLP form made sure he could continue his management role, the estate argued.

But the formation of the FLP simply changed the nature of the trust’s holdings, from directly owning the real property to owning FLP interests, the court observed. The son was still trustee of the trusts that held the partnership interests; and he was the FLP’s general partner. As a result, the FLP “did not resolve [the son’s] conflict of interest . . . nor did it change his roles with respect to the trust,” the court found

2. *Protect the FLP assets from partition.* Most of the properties were located outside of the state, beyond the reach of Hawaiian trust laws. Further, the father’s estate planning attorney never researched the application of trust laws in those other states. “The lack of such basic legal research is telling as to the significance of [the threat of] partition in the decision to form” the FLP, the court observed. In any event, the Hawaiian partition laws would not have applied to the trust-owned properties, and the father had left his personal residence to the



children as joint tenants, without any apparent “fear of partition” or any evidence that they wanted to partition the FLP properties. Thus the “threat of litigation” did not serve a legitimate business purpose, the court held, declining to apply *Estate of Shurtz v. Commissioner*, T.C. Memo 2010-21 (litigious atmosphere in Mississippi sufficient non-tax purpose to form FLP)

3. *Protection from creditors.* Likewise, the court was “skeptical” that the father formed the FLP to protect the assets from creditors, since the estate “failed to name a single” potential claim or “even establish a pattern of activity by the partners” that could expose them to liability.

In addition to these failed assertions of a business purpose, the court also found several “bad facts” that indicated the FLP transfers were not bona fide sales. For example, the FLP failed to follow “even the most basic of partnership formalities,” including keeping regular books and meetings, making proportionate distributions, and refraining from paying the father’s personal expenses and the son’s debts. The father also stood on “both sides of the transaction” in funding and forming the FLP, without any evidence that he held “arm’s length” negotiations with the other partners or created the FLP to fulfill anything but his own objectives. Based on the totality of these facts, the court concluded that the father did not have a legitimate, non-tax reason for transferring his assets to the FLP, which were thus were not “bona fide” sales.

As for the second prong of the 2036(a)(1) test, the court found that by “ignoring” the formal appraisal of FLP assets conducted at the time of its formation, the parties made it difficult to claim now that the LP transfers were for “full and adequate consideration.” The court also found no evidence that the eldest son contributed anything in exchange for his general partnership interest. “We find especially significant that the [FLP] did not maintain a bank account for its first 2 years of existence, leaving no account in which to deposit the contribution,” the court said. The lack of formal accounting also belied the estate’s assertions that the FLP properly credited contributions by the other partners to their respective capital accounts, and the court concluded that the transfers were not for adequate and full consideration.

As a final matter, the court considered the estate’s claims that the father did not retain possession of the FLP assets during his lifetime—but the bad facts of its formation, funding, and operations undermined these arguments as well. Although the father retained some assets outside of the partnership, these were not enough to maintain his lifestyle or satisfy his future obligations, including payment of his estate taxes. Belated attempts by his accountant to “undo” the father’s receipt of disproportionate distributions from the partnership did not “refute the implied understanding that [he] could continue to use and control the partnership property during his life,” the court said.

Lastly, despite some minimal changes to the FLP assets and operation between the time of formation and the father’s death, the “partnership served primarily as a testamentary device through which [the father] would provide for his children at his death,” the court held. Taking this feature in light of all the other factors in the case, the court included the full, fair market value of the FLP assets in the father’s gross estate, pursuant to Section 2036, and denied the estate’s petition.



Discounts in Estate Tax Valuation Do Not Apply to Divorce ***Short v. Short*, 2011 WL 5057209 (Mo. App. E.D. - Oct. 25, 2011)**

When the parties married in 1978, they signed a prenuptial agreement—primarily to protect the wife’s interests in several family businesses, among them a minority interest in a company that held coal-producing properties and a 3% interest in another closely held company. At the time of the marriage, the wife’s 3% interest was worth approximately \$136,000. When the company dissolved nearly 20 years later, it distributed two liquidating payments to the wife totaling \$5.2 million. The wife deposited these amounts in her separate bank accounts.

Husband contests the prenuptial. After 30 years of marriage, the parties divorced. At trial, the trial court upheld the validity of the prenuptial agreement but found that the general rule in the state (Missouri) is that income generated during the marriage, including earnings generated by separate property, is marital property. Because the wife failed to establish that the value of her 3% stock interest increased during the marriage due to anything other than “the accumulation of earnings by a successful business,” the court characterized the entire \$5.2 million in distributions as marital property.

The trial court also heard dramatically different testimony about the wife’s minority interest in the coal company (the appellate court opinion does not reveal the percentage of ownership interest). The wife’s expert appraised the value of her stock at just over \$2.3 million, compared to the husband’s expert, who said the stock was worth closer to \$8.0 million. The valuation by the wife’s expert, however, was based on an outdated appraisal (1999) that had been prepared for estate tax purposes, and reflected a 49.5% combined discount for lack of marketability and control. Such a large discount might be appropriate for determining fair market value in an estate tax situation, the trial court said, but in the current context, the wife would most likely sell her interest to a family member, not a third party.

Accordingly the trial court found the estate tax appraisal to be of “marginal value” in determining the stock’s current worth. The valuation by the husband’s expert, on the other hand, used a net operating income analysis, which was more appropriate for valuing a commercial real estate company. The husband’s expert also used a “conservative” 10% capitalization rate and testified to the impropriety of using the wife’s marketability and minority discount. The trial court credited his \$8.0 million valuation and the wife appealed this finding as well as the characterization of the \$5.2 million distribution as marital property. The husband appealed the enforceability of the prenuptial agreement.

On appeal, the court confirmed that the prenuptial agreement was valid and enforceable under state law. As to the matter of the distributions from the now-defunct company, however, the court found that approximately 97% of the liquidated assets were comprised of retained earnings. In general, retained earnings remain the



company's property until they are "severed" from its other assets, at which point they become dividends and income to the recipient (and marital property under Missouri law).

In this case, however, the retained earnings were never "*severed from other assets* and distributed as dividends," the court emphasized. "Rather, they *comprised the corporation's assets* that were liquidated upon . . . dissolution and distributed to shareholders as liquidating distributions in exchange for and in cancellation of the outstanding shares." Although there was no Missouri case on point, the wife cited a decision in which the Texas Court of Appeals rejected the argument that distributions from a dissolved corporation were "liquidating dividends paid from retained earnings" that should be characterized as community property. Instead, it held that the distributions received in exchange for cancelled stock "retain the character of the stock" and were the spouse's separate property.

The husband tried to distinguish the case by arguing that Texas followed an "inception of title" rule and Missouri followed a "source of funds" rule. Under the latter, property is marital to the extent that marital funds were the source used to acquire it. Since the trial court properly characterized the wife's liquidated distributions of retained earnings as cash dividends or income, the husband argued, they were marital property and the "source of funds" rule would apply.

The court rejected this argument, however, finding the Texas case persuasive. The liquidating distributions from the defunct corporation was not "income earned by her separate stock," the court ruled; "rather, it was liquidated capital distributions received in exchange for, and in cancellation of, her stock interest in [the company], which was her separate property," and it overruled the trial court on this point.

Remand for tracing evidence. At trial, the wife's expert was prepared to testify how he traced the liquidated distributions from their deposit into three of her separate bank accounts in 1999 through the time of divorce. Given its ruling that the funds were marital property, the trial court said such attempts were futile, and barred his testimony. Given its rejection of this ruling, however, the appellate court remanded the case for a redetermination of whether the wife had kept the liquidated funds sufficiently separate since 1999 or had "hopelessly commingled" them with marital funds, thus transmuting their character over the course of the marriage.

As a final point, the appellate court deferred to the trial court's finding that the husband's valuation expert had been more credible than the wife's expert, who relied on an outdated and inappropriate appraisal to value her minority interest in the commercial real property enterprise. "Furthermore, because [the] wife's analysis was discounted as inappropriate," the court held, "the husband's valuation was the only contemporaneous valuation of the wife's interest presented at trial," and it confirmed the \$8.0 million valuation.



Confusion Over ‘Double Dip’ Leads to Triple Appeal

***Heller v. Heller*, 2008 Ohio App. LEXIS 2788 (June 30, 2008) (Heller I);
Heller v. Heller, 2010 Ohio App. LEXIS 5136 (Dec. 14, 2010) (Heller II); and
Heller v. Heller, 2011 Ohio App. LEXIS 4391 (Ohio Ct, App. Oct 18, 2011) (Heller III)**

This litigation began in 2004, when the parties first filed for dissolution after a 30-year marriage. Their primary asset: the husband’s 39.5% interest in a brokerage firm, organized as a Subchapter S corporation. The husband also worked for the company, and drew a base salary of \$300,000 per year plus an annual bonus received as a shareholder distribution.

In particular, the trial court noted that in the five years prior to divorce, the husband’s earnings ranged from just over \$872,000 to \$356,000, with an average annual income of \$614,500. It also noted that both of the parties’ experts, in their valuation of the husband’s business, “normalized” his annual income to his \$300,000 per year. Both experts also applied the capitalization of earnings approach—but only the husband’s expert had analyzed the five-year period of prior income, compared to the wife’s expert, who used the three years prior to divorce (resulting in a higher average).

For this and other reasons, the trial court credited the approach by the husband’s expert and adopted his \$700,000 value, which included a combined minority and marketability discount (the appellate opinions do not reveal the specific percentages). After dividing this asset equally (50/50) between the parties, the trial court determined spousal support in two parts.

First, it awarded the wife \$8,000 per month based on the husband’s “normalized” annual income of \$300,000. Second, it ordered the husband to pay 20% of each payment of additional gross (pretax) income that he received every year from the business. The trial court characterized this as “bonus” income, explaining that “the sole purpose of the additional 20% award . . . was to account for the unpredictable nature of the husband’s income from the company in excess of his salary.”

Husband appeals the ‘double draw from the well.’ On appeal, the husband argued that the trial court impermissibly “double dipped” by distributing his interest in the future profits of his business two times: first when awarded the wife an amount equal to one-half the present value of the husband’s share in the business and then again when it ordered the husband to pay a percentage of his future shareholder distributions.

The appellate court began by noting that there was no Ohio case specifically on point. The wife cited precedent that was inapplicable to the present case: one prior decision concerned the division of a pension fund (not a profit-making asset), for which a particular statutory directive applied; and the second decision concerned three unidentified business entities, for which the valuation method was equally vague and unspecified.

As a result, the court looked to the Ohio marital dissolution statutes, in particular the provisions governing the division of property and the determination of spousal support. The former expressly requires trial courts to



equitably divide marital property “prior to making any award of spousal support . . . and without regard to any spousal support so awarded.” The latter provides that “spousal support does not include any payment made to a spouse . . . that is made as a division or distribution.” Reading these provisions together:

We discern a statutory mandate to keep marital property division and spousal support separate, and to consider the potential “double dip” when ruling upon these issues in cases where one spouse’s ownership in a going concern is discounted to present value and divided, and where excess earnings arising from that ownership interest will constitute part of the spouse’s stream of income into the future.

In this case, the husband’s expert testified that the income approach—and more specifically, the capitalization of earnings approach—was more appropriate to the husband’s business, because 99% of its value was made up of receivables, or “blue sky intangible assets.” He further explained that defendant’s income from the business consisted of dividends, or the return on his investment that arose directly from his ownership interest. His commissions, which were similar to salary, came from his book of business.

Based on this evidence, the trial court appropriately used its discretion to credit the husband’s expert over the wife’s, the appellate court held. However, the trial court abused its discretion “in drawing twice from the same well,” the appellate court ruled, given its interpretation of the marital dissolution statute and the nature of the business in this case. Accordingly, it remanded the case for an award that did not treat the husband’s share of his firm’s future profits “as both an asset and as income for spousal support purposes.”

Trial court makes the same award. On remand, the trial court once again considered the facts of the case, the nature of the husband’s business, and the directive from the appellate court (*Heller I*), and once again it awarded the wife one-half the value of the husband’s interest in the business as well as \$8,000 in spousal support, plus 20% of his annual “bonus” as additional support. Once again, the husband appealed, arguing that the trial court had abused its discretion in failing to follow the law and the Court of Appeals’ directive in *Heller I*.

In a brief, summary opinion (*Heller II*), the Court of Appeals noted that on remand, the trial court had specifically addressed the “double dip” issue, referring to “a variety of journal and internet articles, as well as other states’ cases,” to support its ultimate finding that “a rigid adherence to a rule prohibiting the ‘double dip’ may lead to an unfair result in some cases and . . . instead, guidelines must be developed for the ‘double dip’ situation that will work fairness to both sides of a divorce.” (This appellate court opinion does not provide any detail regarding the cited authorities.)

The Court of Appeals further noted that its first decision (*Heller I*) contained “no language . . . to suggest that this court intended to promulgate a flat prohibition against double dipping applicable to every income-producing asset.” Rather, the court “addressed the ‘double dip’ issue only as it applied to the facts of this case.” And in this case, the court had found that the trial court had unfairly “double-dipped.” On remand, it had therefore been incumbent on the trial court to revise its award so that it did not contain a double dip. However,



the trial court failed to do so, and the court of appeals once again reversed and remanded for findings consistent with its opinions.

On a second remand, the trial court adopted its same distribution of marital property from its prior findings, awarding the wife one-half of the \$700,000 value of the husband's business interest. But this time, instead of awarding the wife 20% of the husband's "bonus" income from the business, the trial court awarded her \$18,000 per month in spousal support. The husband appealed, asserting that the trial court failed to abide by the prohibition against the double dip in this case; or, in the alternative, by making a support award that was unreasonable and "punitive."

Third appeal prompts a strong dissent. In particular, the husband argued that the trial court must have considered the future profits of his business when it ordered the \$18,000 monthly award. However, on reviewing the record, the Court of Appeals could not discern the specific portion of the husband's income that the trial court used in setting the support obligation. Arguably, therefore, the trial court's decision was consistent with the decisions in *Heller I* and *Heller II*.

At the same time, the court agreed that the award of \$18,000 per month was unreasonable, given that the trial court determined the husband's earning capacity solely from his \$300,000 "normalized" salary, but then ordered a support obligation that amounted to \$216,000 per year, or nearly 75% of the husband's stated annual income.

The wife tried to argue that the trial court was not restricted to considering only the husband's \$300,000 income, but that under the marital dissolution statutes, the court was "required" to consider "all sources of income," including any bonus or shareholder distributions. But that contention contradicted the holdings in *Heller I* and *Heller II*, the Court of Appeals ruled. Under the particular facts of this case, its prior decisions specifically restricted the trial court from distributing both the husband's ownership in his business as a marital asset and then, "at the same time," considering his earnings or "bonus" income in determining the amount of support.

This time, instead of remanding the case for a fourth disposition, the Court of Appeals decided that the "better approach" would be to make its own determination, based on the entire record. As a result, it sustained the valuation and division of the husband's business, and ordered him to pay \$8,000 per month in spousal support, remanding the case on the sole issue of whether any arrearages existed.

A strong dissent would have affirmed the \$18,000 award of spousal support, however. "The trial judge, affected by the fact that [the husband] was drawing a profit of approximately \$1 million per year from the Subchapter S Corporation, awarded 21.67% of that amount as spousal support," the dissent noted. The trial court's order was also subject to modification on a showing of changed circumstances—for example, if the company "had a bad financial year."



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In contrast, the majority’s decision effectively awarded the wife, after a long-term marriage, only 10% of the husband’s annual cash flow from the business. Given the rulings of *Heller I* and *Heller II*, the dissent did not believe the trial court had abused its discretion, especially “given the limitations placed upon it by the earlier decisions of this court.”

Given this strong dissent and the protracted nature of this litigation—and the continuing quandary over the double dip, on a public policy as well as practical basis—it’s likely that *Heller v. Heller* will see an appeal to the state Supreme Court. Stay tuned . . .