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Valuation Newsletter

Ninth Circuit Affirms Application of §2036 to FLP

In the Estate of Virginia A. Bigelow v. CIR, No. 05-75957 (9th Cir. September 14, 2007), the U.S. Court of Appeals for the Ninth Circuit considered whether IRS §2036 was appropriately applied such that the value of a residence transferred to a family limited partnership (FLP) should be included in the gross estate of the decedent rather than the value of the limited and general partnership interests.

In 1992, the decedent owned a parcel of real property through her trust. That year she went into a nursing home and her son, an attorney and her attorney-in-fact, took over management of her financial affairs. In that capacity, he formed an FLP. The decedent's trust transferred its real property to the FLP, which did not assume the debt encumbering

the property, and received a 99.8% interest in the FLP, which included a 1% general partnership interest. Her children held the remaining interests in the FLP. As a result of the transfer, the decedent was left in a position where her monthly liabilities exceeded her monthly income.

Between the date of transfer and the date of the decedent's death (August 8, 1997), the decedent's financial position deteriorated. Several annuities and long-term insurance policies lapsed leaving her in a precarious financial position. During this period, the FLP paid the decedent's obligation on the real property she transferred to it. Upon her death, the FLP readjusted the capital accounts and

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Reliance on Business Appraiser Must Be Reasonable and in Good Faith

In the Estate of Josephine T. Thompson v. Commissioner, No. 06-0815-ag (2nd Cir. August, 23, 2007), the U.S. Court of Appeals for the Second Circuit considered whether the estate reasonably relied upon the opinion of value presented by its appraiser and used on its estate tax return such that the accuracy penalty of IRC §6662 should not apply.

The decedent died on May 2, 1998. At that time, she held a 20% interest in Thomas Publishing Co., a closely-held publisher of business-to-business directories with annual income of \$7.9 million.

The principal offices of Thomas Publishing were located in New York City. Nevertheless, the estate engaged an attorney and a CPA in Alaska to value the interest. The attorney and the CPA had never valued a business of this size and complexity. However, the attorney believed that by performing the appraisal in Alaska and filing the return in Alaska, he could achieve some estate tax savings.

The estate adopted the valuation performed by the attorney and the CPA, which concluded that

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*A discussion of recent
estate & gift taxation cases
and IRS pronouncements*

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reduced the decedent's capital account to reflect the principal payments it made on her behalf. Furthermore, the FLP lent her estate funds to cover the funerary costs.

On its estate tax return, the estate reported its 48% limited partnership interest (some of the decedent's interest had been gifted away since the FLP's formation). It determined the value of the real property, calculated the pro rata value of an interest, and reduced that by 37% for lack of marketability and lack of control. With regard to the decedent's 1% general partnership interest, the estate increased the pro rata value by a 35% control premium.

The IRS contested the estate's valuation of the decedent's gross estate. It argued that the decedent and her children had an implied agreement whereby the decedent would retain the economic benefit of the transferred property during her life. Thus, it applied §2036 to recapture the value of the real property in the decedent's gross estate.

The matter proceeded to trial before the Tax Court. The Tax Court agreed with the IRS that the decedent had an implied agreement allowing her to retain the economic benefit of the transferred property. It reached this conclusion because the transfer left the decedent without sufficient revenue to meet her monthly needs and the FLP transferred money to her, subject to a post mortem adjustment in her capital account, to meet the shortfall. It further noted that the FLP did not make corresponding transfers to other partners.

The Tax Court also rejected the estate's argument that the transfer of the property to the FLP in exchange for partnership units fell within the exception to §2036(a) for bona fide transfers for adequate and full consideration. The Tax Court rejected this analysis because a hypothetical person transferring property at arm's-length would not make a transfer that would not allow them to meet their monthly expenses and there were no non-tax benefits of the transfer.

The estate appealed to the Ninth Circuit where it argued that §2036 was inappropriately applied or that it fit within an exception to the statute. The Ninth Circuit affirmed the Tax Court's decision and included the value of the transferred property in the value of the decedent's gross estate.

The Ninth Circuit found that the decedent did retain the economic benefit of the transferred property by way of an indirect agreement. The court noted that the "key problem" with the decedent's transaction was that the decedent transferred only property and not her obligation secured by the property to the FLP, and the FLP paid that obligation without any legal obligation to do so.

The court noted, "Because [the FLP] used funds to make these payments of debt that were derived from income on the property decedent had purported to transfer to [the FLP], it supports the Commissioner's position that the decedent retained an interest in the property." The Ninth Circuit also credited the FLP's failure to follow partnership formalities by not debiting the decedent's partnership account when it paid the loan and debiting the account only post-mortem. Further, it credited the finding that the FLP forwarded the decedent money when she was in financial crises and paid her funeral expenses even though such transfers were labeled as loans. It rejected the estate's argument that the FLP had a "practical liability" to pay to the decedent's obligation on the property in order to avoid losing the property because "whether or not [the FLP] had any practical need to make monthly payments does not undercut the finding that decedent retained the economic benefit from the transferred property."

The court then considered whether the transfer was a bona fide transaction for adequate consideration. The court rejected both parties' contentions. The estate argued that a transfer is bona fide and adequate whenever the decedent receives a pro rata share of the business equal to the value of the property the decedent transferred to the business. The IRS argued that a transaction is not bona fide for adequate consideration where the decedent receives business interests worth less than the value of the property he or she contributed. Rather, the court considered the bona fide transfer for adequate consideration exception to be a single integrated analysis that when viewed objectively requires there be a legitimate and significant non-tax reason for the transfer in addition to a proportionate exchange of value for interests.

The court then considered whether there were any legitimate and substantial non-tax reasons for the transfer. The estate claimed the formation of the FLP protected the partners from liability for personal injury. The

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the interest had a fair market value of \$1.7 million. The estate used a capitalization of income approach, which included a 30.5% capitalization rate. The cap rate included a 12% risk adjustment to account for the uncertainty regarding the change from print to electronic media. The IRS contested this valuation. Its expert valued the business using a discounted cash flow and comparable company approach. He determined that the interest had a fair market value of \$32 million.

The Tax Court rejected the opinions of both party's expert. In doing so, it found the estate's experts "barely credible." Nevertheless, it utilized the capitalization of earnings approach, removing the 12% company specific risk adjustment and reducing the discount for lack of marketability and minority interest from 45% each to 20% each. This resulted in a fair market value of the interest at \$17.5 million.

Despite the significant increase in value it found, the Tax Court declined to levy accuracy-related penalties under IRC §6662. Rather, it found that the exception for reasonable cause found in IRC §6664(c)(1) applied. It reasoned that the valuation was difficult and unique; involved many judgment calls, made more difficult by the uncertainty of the internet on this industry; and while the estate's valuation was aggressive, the court's valuation was closer to the estate's value than to the IRS's value. The IRS appealed.

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court rejected this argument, and it noted that "the Tax Court committed no clear error in rejecting the Estate's proffered non-tax justifications absent some concrete incident or circumstance that reasonably motivated the family to form a partnership to shield itself from liability." It noted that the estate pointed to no evidence of any particular liability or inherent risk of litigation in its business. It further rejected the argument that the business required active management by differentiating the management of a single piece of rental property from management of an active and complex business as in *Kimbell v. U.S.* (oil field management). The court also rejected the estate's argument that the formation of the FLP facilitated gift giving. The court stated, "gift giving is considered a testamentary purpose and cannot be justified as a legitimate, non-tax business justification."

On appeal, the IRS argued that the Tax Court erred when it failed to levy accuracy-related penalties on the estate for its undervaluation. The Second Circuit noted that IRC §6662 is mandatory and provides that the taxpayer will pay a penalty of 40% of the underpayment where its claimed value is not more than 25% of the amount determined to be correct. The court also found that IRC §6664(c)(1) provides an exception "if 'it is shown that there was a reasonable cause for such [underpayment] and that the taxpayer acted in good faith with respect to such [underpayment].'" The court further noted that the §6664 exception is determined on a case-by-case basis under all the facts and circumstances and that reliance on an appraiser's opinion is not necessarily proof of good faith and reasonable cause. The court stated that "reliance on an expert's opinion 'may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.'"

The Second Circuit reversed. It determined that there were no findings regarding whether the estate's reliance on its expert's opinion was reasonable or in good faith. It further noted that the Tax Court did not make any findings whether the estate knew or should have known that the experts lacked the knowledge to perform this valuation. Thus, it remanded the matter for a determination whether the estate's reliance on its expert was reasonable and in good faith, and whether it qualified for the §6664 exception to the accuracy-related penalty.

The court further credited the Tax Court's findings that the decedent's transfer of the bulk of her wealth to the FLP, leaving her without adequate funds, weighed against a finding of legitimate and non-tax purpose as did its finding that the partnership formalities were not followed.

Thus, the Ninth Circuit affirmed the Tax Court's decision and applied §2036 to recapture the value of the property the decedent transferred to the FLP. The court noted however, that "[w]hile FLPs are not vehicles to circumvent estate tax liability per se [citation omitted], we consider whether 'the terms of the transaction differed from those of two unrelated parties' negotiation at arm's length.'"