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Present Value Rather Than Full Value of Built-In Capital Gains Used To Compute Value of Minority Interest

In the *Estate of Frazier Jelke, III, v. CIR*, T.C. Memo. 2005-131, the U.S. Tax Court considered the treatment of capital gains in the valuation of a closely held business. The decedent held a 6.44 percent interest in the company, which held a portfolio of publicly traded stocks and bonds and which regularly issued dividends. The portfolio was professionally managed, with an eye toward long-term growth. The portfolio was turned over at an average rate of 5.95 percent per year and had an average annual growth rate of 23 percent through 1998. The company had substantial built-in capital gains taxes. The decedent died on March 4, 1999. At that time, the company had net assets of $188.6 million and a built-in capital gains tax liability of $51.6 million.

The estate had a professional appraiser value the decedent's interest for estate tax purposes. The expert valued the company using its net asset value, which included a liquidation premise as required under *Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002). Thus, he deducted the full amount of the built-in capital gains taxes. He then applied a 20 percent discount for lack of control and a 35 percent discount for lack of marketability. The IRS contested this valuation.

"The major point of contention was the appropriate amount of built-in capital gains taxes to deduct when valuing the business."

The major point of contention was the appropriate amount of built-in capital gains taxes to deduct when valuing the business. The IRS' expert disagreed with the position taken by the estate's expert and estimated the net present value of the full amount of built-in capital gains taxes. In doing so, he first computed the average annual turnover rate (5.95 percent). He then determined that it would take 16.8 years to fully realize the full amount of the built-in capital gains taxes by dividing the average annual turnover rate into 100. He next computed the amount of tax realized annually by dividing the number of years required into the full amount of built-in capital gains. He discounted annual capital gains tax realized in each of the years to present value using a discount rate of 13.2 percent. He concluded that the proper amount of built-in capital gains taxes to consider in valuing the business was $21.1 million.

The Tax Court first applied the hypothetical willing buyer-seller test. It considered what the hypothetical purchaser of decedent's interest was buying, a right to share in the long-term capital growth by receiving future dividends, and he would not have the ability to force a liquidation. It also considered that the hypothetical seller of the interest would not accept a price that included a full realization of the built-in capital gains. Thus, it concluded that neither hypothetical party would fully account for built-in capital gains in reaching their purchase price.

The Tax Court also differentiated this case from *Dunn*. It noted that *Dunn* involved the valuation of a controlling interest in an operating company, whereas here it was valuing a minority interest in a holding company. It further noted, "In that regard, the Court of Appeals tempered its holding in *Estate of Dunn* by explaining that if it were valuing a minority ownership interest, a business-as-usual assumption earnings-based approach may be more appropriate." Moreover, it concluded that in any event, this case was not appealable to the Fifth Circuit but to the Eleventh Circuit, which had not addressed the issue of built-in capital gains.

After considering the hypothetical willing buyer and seller and the legal precedent involving built-in capital tax discounts, the Court adopted the position espoused by the IRS' expert. ■

New Strangi Decision Further Clarifies Bona Fide Exception

In *the Estate of Albert Strangi v. CIR*, No. 03-60992 (5th Cir. July 15, 2005), the U.S. Court of Appeals for the Fifth Circuit considered whether a transfer of assets to a family limited partnership (FLP) met the sec. 2036 exclusion for a bona fide sale. Two months before the decedent's death in October 1994, his son-in-law/attorney-in-fact established a FLP and transferred the bulk of the decedent's estate to the FLP. The decedent received a 99 percent limited partnership interest and a 47 percent interest in the corporate general partner. His children and a community college (which held only a .25 percent interest) held the remainder of the corporate general partner. The decedent held only $726 dollars in cash and $187,000 in securities after the transfer. The estate reported the fair market value of the FLP interest on its estate tax return, which the IRS contested.

The Tax Court held that sec. 2036 applied because the decedent retained the use and enjoyment of the property during his lifetime and the transfer was not a bona fide sale for adequate and full consideration in money or money's worth. The estate appealed the decision.

The Fifth Circuit affirmed the Tax Court's decision applying sec. 2036 to the facts of this case. It first addressed the estate's argument that the decedent did not retain the economic benefit from the transferred assets. The Fifth Circuit noted that the Tax Court found the following facts: the decedent was left with insufficient money to fund the remainder of his life when his income and retained assets were compared to his average monthly expenses and life expectancy; he lived in a house transferred to the FLP without paying any rent in life although rent accrued on the FLP's books; and the FLP declared distributions whenever the decedent ran short of money although the distributions were made pro rata to all the partners. These facts together provided a sufficient inference that the decedent and his children had an implied agreement that he would retain the enjoyment from the assets during his lifetime.

" The Fifth Circuit affirmed the Tax Court's decision applying sec. 2036 to the facts of this case."

The Fifth Circuit also addressed whether the transfer to the FLP was a bona fide sale for adequate and full consideration. The court first noted that the transfer was for adequate and full consideration because the decedent's assets were transferred to the FLP for a proportional interest therein and the partnership formalities were respected.

Like the Tax Court, the Fifth Circuit concluded that the transfer was not a bona fide sale. The Fifth Circuit noted that a bona fide sale is one which objectively serves a substantial business or other non-tax purpose at the time the FLP was formed.

Importantly, the Fifth Circuit analyzed the estate's claims that the FLP was a joint investment vehicle that provided the opportunity for active management of its working assets. The court acknowledged the Strangi children's de minimus interest in the FLP through their interest in the FLP's corporate general partner, but concluded that no joint investment existed because the FLP did not make any investments or undertake any active business following its formation. The Fifth Circuit stated, "It is certainly true that the de minimus contribution of a minority partner is not, in itself, sufficient grounds for finding that a transfer of assets to a partnership is not bona fide. However, where a partnership has made no actual investments, the existence of minimal minority contributions may well be insufficient to overcome an inference by the finder of fact that joint investment was objectively unlikely."

The Fifth Circuit also noted that while the bulk of the assets transferred to the FLP were securities, roughly 11 percent were interests in real property or real property companies. The estate claimed that this percentage of working assets was similar to the percentage of working assets transferred to the FLP in *Kimbell v. USA*, 371 F.3d 257 (5th Cir. 2004), which involved oil and gas interests. The court rejected this analogy noting that in *Kimbell* the parties agreed that the working assets were actively managed, whereas here the working assets were not actively managed. The court stated, "In short, although Strangi may have transferred a substantial percentage of assets that <u>might have been</u> actively managed under SFLP, the Tax Court concluded, based on substantial evidence, that no such management ever took place. From this, the Tax Court fairly inferred that active management was objectively unlikely as of the date of SFLP's creation." (Emphasis in original). Thus, the Fifth Circuit rejected the estate's argument that the mere

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New Strangi Decision Further Clarifies Bona Fide Exception

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presence of working assets provided support for a bona fide sale.

The Fifth Circuit, thus, affirmed the Tax Court's application of sec. 2036 to recapture the value of the transferred assets for estate tax purposes. ■

Fully Documented and Supported Appraisal Reports Significant to Recovery of Costs and Fees

In *Estate of John L. Baird v. CIR*, No. 03-60855 (5th Cir. July 11, 2005), the U.S. Court of Appeals considered whether an estate should recover the administrative and litigation costs involved in defending its valuation. The decedent and his wife each held, in trust, small undivided interests in 16 tracts of timberland in Louisiana. The remaining interests were held by members of the decedents' family. The decedent died December 18, 1994 and his wife died 11 months later. His estate obtained a valuation of the property that included a 25 percent fractional interest discount. This discount was the mean discount applied in two precedential Tax Court cases, which were cited in the appraisal report. The wife's estate also obtained a valuation. Her estate reported a 50 percent fractional interest discount determined by an appraiser, who concluded that in-kind partition was unlikely and considered sales of comparable undivided minority interests.

The IRS also obtained an appraisal. Its appraiser determined that the opportunities for partition in-kind were likely because remaining interests were held by members of the same family. Thus, he concluded that only a 3.37 percent and a 3.11 percent discount for the costs of partition should be applied to each estate respectively. The IRS issued a notice of deficiency based on its appraiser's position that no discount beyond the costs to partition was warranted.

The matter proceeded to trial before the Tax Court. The estate provided various expert valuation witnesses as to the appropriate size fractional interest discount to be applied to the value of the 16 timber tracts. The IRS presented the author of its appraisal as an expert, but the Tax Court determined that the expert was not "specifically qualified to assist the trier of fact (Court) on the question of the discount to be applied, if any, to a fractional interest in timberland." Undeterred by the exclusion of its witness, the IRS maintained the position that no fractional interest discount beyond the costs to partition should be permitted. The Tax Court ultimately applied, based on the expert testimony provided by the estate, a 60 percent fractional interest discount. While granting a victory to the estate, the Court declined to award it administrative and litigation expenses under sec. 7430 because it found the IRS' position was substantially justified. The estate appealed.

"The Tax Court ultimately applied, based on the expert testimony provided by the estate, a 60 percent fractional interest discount."

Before the Fifth Circuit, the estate argued that the IRS' position that no fractional interest discount should have been applied was not substantially justified. The Fifth Circuit initially noted, "The court considers all of the facts and circumstances surrounding the dispute to determine whether the IRS knew or should have known that its position was invalid." The Fifth Circuit disagreed with the Tax Court and found that the IRS was substantially on notice as of the date of deficiency that the IRS' position was substantially unjustified. It noted that the appraisal report attached to the decedent's estate tax return cited *Estate of Cervin v. Commissioner*, 68 T.C.M. 1115 (1994) and *Lefrank v. Commissioner*, 66 T.C.M. 1297 (1994) for the position that a fractional interest discount should apply and attached copies of the decisions as exhibits. Moreover, the decedent's estate tax return included a statement citing the Tax Court's decision in *Estate of Bright v. United States,* 658 F.2d 999 (5th Cir. 1981), which held that family attribution should not be considered in determining value. The statement noted that under *Bright*, the subject interest should be valued as though it were being purchased by a hypothetical willing buyer. Further, the statement indicated that partition could only be accomplished by agreement of all the fractional interest owners and such consent was likely to be withheld in this case. This position was expounded upon in the appraisal report attached to the decedent's wife's estate tax return, which discussed the problems associated with partition in-kind and control of timberland under Louisiana law as support for his 50 percent fractional interest discount.

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Fully Documented and Supported Appraisal Reports Significant to Recovery of Costs and Fees

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The Fifth Circuit held that the IRS should have known the relevant legal authority before proceeding with its litigation position. It noted that the Fifth Circuit issued the *Bright* decision regarding family attribution and issued a decision in *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996), which held that costs of partition are only one among many considerations that go into valuing a fractional interest discount.

The Fifth Circuit held that the IRS' position was substantially unjustified because the IRS had a duty to know the legal authority and was put on notice of that authority by the estates in the appraisal reports attached to their estate tax returns. Thus, it remanded the matter for a determination of the amount of litigation costs the estates should recover. ■

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