
THE HEMPSTEAD LETTER

Estate and Gift Tax Valuation Edition

Vol. XXIII, No. 5

Tax Court Sets FLP Discounts for Lack of Marketability and Minority Interest

In the *Estate of Webster E. Kelley v. CIR*, T.C. Memo. 2005-235, the U.S. Tax Court considered the appropriate lack of marketability and minority interest discounts to apply to an interest in a family limited liability partnership. The decedent established the FLLP six months prior to his death. He transferred \$1.1 million in cash and certificates of deposits to the partnership and received a 94.83 percent limited partnership interest. A limited liability company (LLC) was formed to hold the general partnership interest. The decedent held a one-third interest in the LLC. His daughter and her husband each held a one-third interest as well. The decedent died on December 8, 1999. His date of death was the valuation date.

The estate engaged a credentialed business appraiser to value the interest for estate tax purposes. The appraiser applied a 53.5 percent combined discount to the net asset value of the partnership assets. The IRS audited the tax return. The parties stipulated to the value of the partnership assets at \$1.2 million. They disagreed regarding the appropriate size discounts for lack of marketability and minority interest.

The estate's expert and the IRS' expert, an economist, agreed that the minority interest discount should be determined by reference to discounts from net asset value observed in closed-end funds. They differed on their approaches. The estate's expert utilized data from publicly traded closed-end funds, which he separated into quartiles. He determined that the subject company should be compared with closed-end funds in the fourth quartile because (1) the subject company was smaller than the publicly traded funds, (2) the subject company lacked professional management, (3) the closed-end funds had greater diversity of assets, and (4) the subject company lacked an established operating history. The funds in the fourth quartile indicated a

discount between 21.8 and 25.5 percent from net asset value. The estate's expert also considered data from two Partnership Profiles, Inc. studies, which indicated discounts from net asset value of 29 and 27 percent respectively. The estate's expert concluded that the appropriate minority interest discount was 25 percent.

The IRS' expert rejected the estate's expert's approach because the quartile analysis implicitly included characteristics of marketability, which the estate's expert also acknowledged. In order to account for the marketability characteristics, this expert utilized the entire sample of closed-end funds and computed the arithmetic mean, which was 12 percent.

“Thus, the Tax Court applied a 23 percent discount for lack of marketability.”

The Tax Court agreed with the IRS' approach. It relied on the basic premise that “[a]s similarity to the company to be valued decreases, the number of required comparables increases.” Thus, it reasoned that since all shareholders of all closed-end funds lack control, the effects of marketability inherent in fund price would be minimized by use of the largest sample. Thus, it adopted the IRS' expert's 12 percent. However, it did so grudgingly, treating the IRS' position as a concession, and pointed to the decision in *Peracchio v. CIR*, T.C. Memo. 2003-280, which allowed only a 2 percent minority interest discount to the cash and marketable securities portion of the holdings.

The Court next considered the experts' positions with respect to a discount for lack of marketability. The estate's expert utilized the restricted stock studies and then considered factors specific to the

continued on next page

Tax Court Sets FLP Discounts for Lack of Marketability and Minority Interest

continued

terms of this partnership. Those restrictive terms included the inability to transfer, assign, or withdraw without the consent of all the remaining partners; the inability to hold the general partner accountable for malfeasance; the potential for dilution if capital contributions were not made when called for; and others. He concluded that the appropriate lack of marketability discount was 38 percent.

The IRS' expert relied upon the Bajaj private placement study. While the study indicated that the average discount was 14.09 percent, the IRS's expert utilized a 15 percent discount. In reaching this determination, the expert acknowledged the low risk associated with the subject company's portfolio.

The Tax Court rejected both experts' analyses. It found that the restricted stock studies were inapplicable under this situation because they analyzed operating companies rather than investment companies, such as the subject company. Moreover, it noted that the estate's expert made no attempt to correlate the studies' underlying data to the subject company.

The Tax Court then re-expressed its preference for discounts based on private placement studies when the subject company is an investment company. It adopted the use of the Bajaj private placement study under the facts of this case, but rejected the expert's application. It noted that the IRS' expert's discount was based on the low end of the study's range, and the author of the study acknowledged that the low end contained elements not associated with marketability. The Court then looked to its decision in *McCord v. CIR*, 120 T.C. 358 (2003) for guidance. *McCord* utilized the Bajaj study based on three ranges of discounts. In that case, the Tax Court, using the Bajaj study, determined that a 20 percent discount was appropriate for a family limited partnership classified as an investment company. The Tax Court here adopted that position as its starting point. To that it added 3 percent for company specific restrictions. It utilized a 3 percent discount based on its holding in *Lappo v. CIR*, T.C. Memo. 2003-258. In *Lappo*, the Court

increased the lack of marketability discount by 3 percent from the baseline it selected for company specific factors including (1) the inability to go public, (2) the small size of the subject company, and (3) the partnership's right of first refusal on any sales. The Tax Court found the facts identified in *Lappo* were similar to those identified by the estate's expert here, and therefore adopted that increase. Thus, the Tax Court applied a 23 percent discount for lack of marketability. ■

Land and Timber Summation Rejected by Court

In the *Estate of Nora Kolczynski v. CIR*, T.C. Memo. 2005-217, the U.S. Tax Court considered the valuation of several parcels of real property. The decedent held a 100 percent interest in Dawn Plantation on the date of her death – July 8, 1999. The date of death was the valuation date. Dawn Plantation was comprised of six tracts totaling 2,095.12 acres. The largest tract was 1,931.30 acres. The plantation was located in Ashepoo, Combahee, and Edisto Rivers Basin of South Carolina. It was primarily utilized as timber and recreational property.

The estate engaged a real property appraiser to determine the value of the land. He valued the land at \$2.826 million based on the comparable sales method. The estate also obtained an appraisal of the standing timber. The timber was valued at \$2.666 million. The final valuation of the property was performed by a CPA, who also held a J.D. He considered the appraisal of the underlying assets and valued the property as a sole proprietorship. In doing so, he adopted the valuation of the standing timber but removed standing timber tracts of less than \$1,000 from the valuation because he determined the removal of that timber would negatively impact the value of the immediately surrounding land. Thus, he valued the timber at \$2.440 million. He rejected the appraisal of the land valuation. Rather, he utilized a method based on the state of South Carolina's assessed value (80 percent of fair market value). Thus, he determined that the fair market value of the land was \$1.470 million. The CPA reported the value of Dawn Plantation as a sole proprietorship at \$4.378 million.

continued on next page

Land and Timber Summation Rejected by Court

continued

The IRS audited the estate's tax return. It rejected the sole proprietorship premise of valuation. It then adopted the timber and land appraisals commissioned by the estate and attached to the tax return. Under the summation approach, it added the values together, and concluded that the property had a value of \$5.490 million. The matter proceeded to trial before the Tax Court.

The estate abandoned the position it had taken in its tax return. Rather than arguing that the property should be valued as a business, it introduced an additional real property appraisal, which valued the entire parcel under a comparables property approach. Nonetheless the Court considered, but did not rely upon the appraisal prepared by the CPA and attached to the tax return. (It is important to note that the CPA who authored this opinion died prior to trial). However, the Tax Court did rely upon the appraisals of the land and timber that were considered by the CPA and attached to the tax return.

After considering the approaches presented at trial and the underlying appraisals of the property attached to the tax return, the Tax Court rejected both the sole proprietorship and summation premises as applied to the valuation of this property. It relied upon a valuation based on a comparable parcel, which was smaller but adjacent to the main parcel at issue here. The comparable sale occurred two years before the valuation date. Thus, the court applied adjustments for timber, time, water and frontage, and concluded that Dawn Plantation had a fair market value of \$4.829 million on the valuation date. ■

Massachusetts Considers GRATs in the Wake of Strangi

The Internal Revenue Service has increasingly utilized sec. 2036 to dispute estate tax planning strategies of taxpayers since the decision in *Estate of Strangi v. CIR*, 85 T.C. M. 1331 (CCH 2003), aff'd, 417 F.3d 468 (5th Cir. 2005). Under sec. 2036, the value of property transferred by the decedent over which he or she retains the enjoyment from or

the ability to appoint, alone or in conjunction with others, who will enjoy the transferred property, will be included in the value of the decedent's gross estate. Sec. 2036 has been used to look through family limited partnerships in many recent cases including *Estate of Bongard v. CIR*, 124 T.C. No. 8 (March 15, 2005) and *Estate of Bigelow v. CIR*, T.C. Memo. 2005-65. While the current application of sec. 2036 has been applied only to family limited partnerships and family limited liability companies, there is concern that the application of sec. 2036 will be extended beyond those tax minimization vehicles.

"Freedman feared that... the IRS would... apply sec. 2036..."

In *Lillian R. Freedman, settlor, et al. v. Lillian Z. Freedman, trustee, et al.*, SJC-09475 (MA September 20, 2005), the Supreme Court of Massachusetts considered a declaratory judgment action to reform three grantor retained annuity trusts (GRATs). The Freedmans operated several successful real estate investment businesses through limited liability companies. In order to minimize the estate transfer taxes, the settlor established the GRATs to effect the transfer of control of the business to her sons. The GRATs contained a clause granting the settlor the power to appoint successor trustees. Freedman feared that as a result of that power, she would be deemed by the IRS to have, along with her sons, the power to affect the timing and amount of distributions from the limited liability companies and, thus, the IRS would attempt to apply sec. 2036 to look through the GRATs should she die before their terms expire.

The Massachusetts Supreme Court noted that the reformation of a trust agreement turns on the intent of the settlor. It noted that here, the settlor's intent to minimize federal estate taxes was evinced by her direct testimony, and there was no question as what her intent was at the time of the GRATs' formation. Thus, the court granted the declaratory action and permitted the reformation of the trusts as to remove the power to appoint successor trustees from the settlor and place that power with her sons.

In granting this remedy, the court noted, "As to *continued on next page*

Massachusetts Considers GRATs in the Wake of Strangi

continued from page 3

whether the reform the plaintiffs seek would in fact make a difference to the settlor's estate tax liability, i.e., whether the *Strangi* case would apply to the trust arrangement involved here, 'we make no judgment as to the actual tax implication of the [trusts] as reformed but simply reform [the trusts] to effectuate the [settlor's] intentions at the time she established [the trusts].'" ■

The material presented in the Hempstead Letter should not be construed as definitive legal, accounting, financial, or business advice nor should it be acted upon without consultation with legal or other professional counsel.

Hempstead & Co. is a financial consulting firm providing services in the following areas:

- *Valuations of Businesses and Corporate Securities*
- *Fairness Opinions*
- *Valuations of Stock Options*
- *Valuations of Intangible Assets*
- *Loss of Business Damage Analysis*
- *Mergers & Acquisitions*
- *Purchase Price Allocations*
- *Goodwill Impairment Testing*

Professional designations of our staff include Accredited Senior Appraiser, American Society of Appraisers (ASA), and Chartered Financial Analyst (CFA). We welcome the opportunity to serve you. Please call Mark Penny at (800) 541-3323 or contact him via e-mail at jmpenny@hempsteadco.com.

We'd like to hear from you! Please contact us regarding information found in *The Hempstead Letter*, or with any mailing address updates.



Hempstead & Co. Inc.

807 Haddon Ave.

Haddonfield, NJ 08033

ADDRESS SERVICE REQUESTED

IN THIS ISSUE:

- ***Kelley FLP Discount Decision***
- ***A Timberland Valuation Case***
- ***Making a GRAT Strangi-Proof***