THE HEMPSTEAD LETTER

Estate and Gift Tax Valuation Edition

Vol. XXIV, No. 1

Lack of Business Appraisal Is One Indicator That Note Transaction Was Not Bona Fide

In the *Estate of Winifred Hughes v. CIR*, T.C. Memo. 2005-296, the U.S. Tax Court considered whether an amount paid on a demand note after the death of the decedent was deductible under sec. 2053 as a claim against the estate. The fact that a business appraisal was not obtained in connection with the note transaction played an important role in the court's analysis.

The decedent's husband established a used automobile dealership. The dealership was not profitable and borrowed money from related wholly-owned entities. In 1996, the husband died. At that time, the dealership was insolvent and the estate reported it had a value of zero.

All the dealership's stock was held in trust for the decedent following her husband's death. She never was involved with the business of the dealership. Management of the dealership was left to the executor of the husband's estate, who had power of attorney over the decedent following the death of her husband and would become her executor.

"... a valuation was not obtained in connection with the transaction."

In 1997, the dealership turned a modest profit of $29,663 on sales of $1.9 million. However, it owed $964,257 to a family limited partnership. The general partnership interest was held by the decedent's trust and the limited partnership interests were held by the decedent's children and grandchildren. That year the executor in his capacity as manager of the dealership and as the decedent's attorney in fact sold 4,000 shares of the dealership to the decedent for a $400,000 demand note. Negotiations regarding the transaction did not occur and a valuation was not obtained in connection with the transaction. Furthermore, the existence of the transaction was not disclosed to the accountants and bookkeepers of the dealership.

In 1999 the decedent passed away. Between 1997 and the valuation date, the decedent did not make any principal or interest payments on the note nor did the dealership demand any payments. Upon her death, the executor made a demand upon the estate which paid the amount due. $400,000 was transferred from the estate to the dealership and then from the dealership to the FLP. The estate claimed a deduction of $400,000 under sec. 2053. It also reported the value of the dealership to be zero because it had returned to its insolvent state. The IRS denied the deduction and the matter proceeded to trial before the Tax Court.

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Valuation Discount Issue Not Reached Due to Problems With FLP Formation

In *Mark W. Senda v. CIR*, No. 05-1118 (8th Cir. January 6, 2006), the U.S. Court of Appeals for the Eighth Circuit considered whether a transfer of publicly traded stock to a family limited partnership (FLP) made close in time to a gift of FLP interests was an indirect gift of the pro rata share of the public stock for gift tax purposes. The Sendas formed two FLPs: one in 1998 and in 1999. The FLPs were similarly formed: the Sendas held the general partnership interest and all the limited partnership interests except .03 percent. A .01 percent interest was held by each of their three children.

After formation, the Sendas capitalized the FLPs with publicly traded MCI WorldCom stock. The Sendas contributed $2 million in stock to FLP I in 1998 and $1.5 million to FLP II in 1999. The children contributed unsecured promissory notes representing their pro rata contribution, which amounted to less than $200 each.

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The Tax Court initially noted, "An estate may deduct the value of a claim based on a decedent's promise to pay only if the liability was contracted bona fide and for full and adequate consideration in money or money's worth."

The Court first addressed the question of adequate consideration. The Court received testimony from the dealership's attorney that the dealership had negligible value on the date of the transaction. The Court noted that the business had a negative net worth at times despite the transaction and the modest 1997 profit. Lastly it found that the post-death payment of the demand note directly benefited the children and grandchildren associated with the FLP. Thus, the court concluded, "We do not believe that the value of … [the dealership's] stock increased from zero on April 10, 1996 (as reported on the estate tax return for … [the decedent's husband and signed by the decedent's executor]) to $400,000 on April 29, 1997, and then fell to zero on July 25, 1999…." Therefore, the Court concluded that the stock had no value on the date of the transaction and the transaction did not occur for full and adequate consideration.

"... the Court found that (the) transaction was a testamentary disposition..."

The Court next determined whether the transaction was bona fide, which it defined as "in good faith and bargained for at arm's length." The Court considered several factors in analyzing this question. Pertinent among these was the fact that a business valuation was not performed in connection with the transaction. Other facts included that the executor stood on both sides of the transaction, the corporate accountants were unaware of the transaction, and the dealership made no demand for payment during the decedent's life. Therefore, the Court concluded that the transaction was not bona fide.

Since the transaction was not bona fide and was not made for adequate and full consideration, the amount paid under the note to the dealership was not a deductible claim under sec. 2053. Rather, the Court found that this transaction was a testamentary disposition for the benefit of the decedent's children and grandchildren. ■

Valuation Discount Issue Not Reached Due to Problems with FLP Formation

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On the same day that the FLPs were capitalized, the Sendas gifted their children limited partnership interests in the FLPs. The Sendas reported the fair market value of the gifts inclusive of discounts for lack of marketability and lack of control (minority interest).

"... the court affirmed the Tax Court's characterization of the transactions under the step transaction doctrine."

The IRS contested the valuation of the gift. It argued that the transfer to the children was an indirect gift of the underlying public stock. The Tax Court agreed with the IRS' position. T.C. Memo. 2004-160.

The Tax Court held that in order for the gift to have been a direct gift of the FLP interests, which would raise the issue of the application of discounts resulting from the FLP form, the Sendas were required to prove that they capitalized the FLPs before making the gifts. Based on the lack of documentary support and the equivocal testimony of the petitioner, the Court determined, "At best, the transactions were integrated …, and, in effect, simultaneous." Therefore, it applied the step transaction doctrine and concluded that an indirect gift had been made of the underlying public stock. This decision mooted the applicability of discounts issue.

The Sendas appealed to the Eighth Circuit where they argued that the Tax Court erroneously found that the evidence did not conclusively show that the gift occurred after the capitalization of the FLPs or alternatively it erred in applying the step transaction doctrine to consolidate the capitalization and the gift transactions. The Eighth Circuit initially noted, "This sequence [of the transactions] is critical, because a contribution of stock *after* the transfer of partnership interest is an indirect gift to the partners (to the extent of their proportionate interest in the partnership)." (Emphasis in original). The Eighth Circuit then declined to disturb the Tax Court's decision, noting that the petitioner's testimony conflicted with his documentary evidence making both unreliable. Therefore it affirmed the Tax Court's decision that the transactions were effectively simultaneous.

It further affirmed the application of the step transaction doctrine to the facts of this case. It defined the doctrine as "In some situations, formally distinct steps are considered as

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Issue of Valuation Discounts Not Reached Where Problems with FLP Formation Indicate Indirect Gift of Contributed Assets

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an integrated whole, rather than in isolation, so federal tax liability is based on a realistic view of the entire transaction." The court found that based on the testimony of the petitioner, he was concerned that the transactions occurred on the same day and not with the order of the transactions. Therefore, the court affirmed the Tax Court's characterization of the transactions under the step transaction doctrine. ■

Buy-Sell Agreements Less Effective in Value Reduction When Decedent Retains Controls

Buy-sell agreements are a commonly used mechanism to control the transfer of closely-held stock by stipulating to whom and at what price the stock may be transferred. The presence of a buy-sell agreement is one factor to be considered in determining the fair market value of stock for estate and gift tax purposes. A buy-sell agreement may conclusively establish the fair market value of the subject stock when it satisfies several conditions. These conditions include that: (1) the price is fixed and determinable under the agreement; (2) the agreement is binding upon the parties in life and death; (3) the agreement has a bona fide business purpose (this may be satisfied by retention of family control or ownership); (4) the agreement must not be a testamentary device; and (5) the agreement must be comparable to those entered into by third parties at arm's-length. *Estate of Lauder v. CIR*, T.C. Memo. 1992-736; I.R.C. sec. 2703.

Where the buy-sell agreement does not satisfy all the above conditions and the estate relies upon the buy-sell agreement to establish the fair market value of the stock, the price indicated by the buy-sell agreement is not determinative of the fair market value of the stock and any consideration of the effect of the buy-sell agreement on the value of the subject stock may be disregarded.

Where a decedent has a controlling interest in the business subject to the buy-sell agreement, the buy-sell agreement runs afoul of the *Lauder* test and sec. 2703. In *Estate of Blount v. CIR*, No. 04-15013 (11th Cir. October 31, 2005), the decedent held 83 percent of a road construction company, which was subject to a buy-sell agreement between the company and him. The decedent unilaterally changed the repurchase terms from adjusted book value to a fixed amount based on what the company needed to continue to operate. The remaining stock was held in an employee stock ownership plan, which was not a party to the buy-sell agreement.

The Eleventh Circuit affirmed the Tax Court and held that the buy-sell agreement did not establish the fair market value of the business for estate tax purposes because the buy-sell agreement did not satisfy several prongs of the *Lauder* test. The court reasoned that since the decedent could and did unilaterally alter the price terms of the buy-sell agreement while he was alive, the agreement was not binding on him in life and death. Despite expert evidence to the contrary, the agreement was not similar to agreements entered into at arm's-length by third parties because the expert's opinion failed to consider the business' non-operating assets.

"The Eleventh Circuit... held that the buy-sell agreement did not establish the fair market value..."

Where *Blount* looked to establish the value of stock by reference to a buy-sell agreement, the discount for lack of marketability attributable to a buy-sell agreement may be at risk where the terms of the buy-sell agreement do not satisfy the sec. 2703 factors and the *Lauder* test. In *Sidney E. Smith III v. U.S.A.*, No. 02-264-Erie (W.D. Pa. July 22, 2005), the decedent formed a family limited partnership (FLP) with his son to hold a family owned business entity. The FLP agreement contained an option in favor of the partners to purchase the stock on favorable terms carrying interest at the applicable federal rate (AFR). The decedent held the general partnership interest and the majority of the limited partnership interests at all times. He reported the fair market value of gifted limited partnership interests inclusive of a lack of marketability discount, which factored the presence of the buy-sell agreement into the discount size. The Western District of Pennsylvania held that the sec. 2703 applied to disregard the discount for lack of marketability attributable to the buy-sell agreement. The court reasoned that IRC sec. 2703 supplemented pre-existing law. While sec. 2703 does not have a binding in life and death requirement, the pre-existing *Lauder* test does. Since the decedent controlled the FLP in life, the buy-sell provision in the FLP agreement was not binding upon him in life and death. Therefore, the discount attributable to the buy-sell agreement was disregarded.

The cases of *Blount* and *Smith* clearly show the pitfalls to successful use of buy-sell agreements for estate minimi-

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Buy-Sell Agreements Less Effective in Value Reduction When Decedent Retains Controls

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zation where the decedent retains control over the subject entity at the time of his or her death. The harsh result observed in *Blount* and *Smith*, however, should be tempered by consideration of *Estate of True v. CIR*, (10th Cir. No. 02-9010 December 2, 2004), which held "The case law does generally indicate that the restrictive impact of a buy-sell agreement should be considered as a factor in valuing the interests for estate and gift tax purposes even if its specific price terms are held not to be controlling. We agree that the existence of such a restrictive agreement, and the bona fide business reasons supporting it, should be acknowledged when determining the fair market value of an interest." ■

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Hempstead & Co. Inc.
807 Haddon Ave.
Haddonfield, NJ 08033

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