

Taxpayer victory on FLP recognition

by Bruce A. Johnson*

Church v. United States, No. SA-97-CA-07740OG, 2000 U.S. Dist. LEXIS 714 (W.D. Tex January 18, 2000). Judge Garcia.

Key Words:

Family limited partnership, Discount for lack of control, Discount for lack of marketability, Partnership formation, Gift, IRC § 2051, IRC § 2051, Bona fide business arrangement, Income approach, Market approach

On Jan. 18, 2000, Judge Orlando Garcia of the United States District Court ruled in favor of the taxpayer in the first family limited partnership case to be tried in a federal district court. The family limited partnership, Stumberg Ranch Partners, Ltd., was formed two days prior to the unexpected death of Mrs. Church. The partnership held a 57.06% undivided interest in a 23,000-acre West Texas ranch and approximately \$1 million of marketable securities. The undivided interest in the ranch was appraised by a separate real estate appraisal for \$612,965, which included a 25% discount for lack of control due to the undivided nature of the property. The ranch was leased for grazing and hunting. Members of the Drake family owned the other 43% interest in the ranch.

Upon formation, Mrs. Church contributed a 37% undivided interest in the real estate and 99% of the marketable securities. Miller, the son of Mrs. Church, and Newton, the daughter of Mrs. Church, each contributed a 10% undivided interest in the real estate and the remaining marketable securities. The market value of the assets of the Partnership is shown as follows:

Money Market Securities	\$132,018
Municipal Bonds	\$277,033
Stocks	\$679,103
57.06% Undivided Interest in Ranch	<u>\$612,965</u>
Net Asset Value	\$1,701,119

The partnership agreement entitled Mrs. Church to 62% of the income from the real estate interest and 99% of the income from the marketable securities. This allocation was based on the partner's initial contribution percentages. The general partner of the partnership was Stumberg Ranch, LC, and

was owned equally by Miller and Newton. However, the corporation was not formed until five months after the formation of the Partnership.

Valid partnership agreement

Prior to the trial, the Government filed a motion claiming that the partnership did not exist under Texas law because a Certificate of Limited Partnership had not been filed with the State of Texas prior to death. The Court rejected this theory, but the Government raised the issue again at trial because the name of Mrs. Church's brokerage account had not been changed to the partnership's name until five months after her death. The Court found that the partnership had legal title to the brokerage account and stated that even if it did not have legal title, Texas law states that ownership of property intended to be in a partnership is determined by the intention of the parties, not legal title.

Gift not made

The Government argued that at the partnership's formation, the difference between the value of the property contributed by Mrs. Church and the value of the limited partnership interest that she received in exchange must be taxed as a gift under IRC § 2051. The Court found that no gift was made, because no one experienced a financial benefit or any increase in wealth. Each partner received the same proportional interest that was contributed at the formation of the entity.

Assets not "property"

The Government claimed that the definition of the term "property" as used in IRC § 2703 refers to the assets that were contributed to the partnership by Mrs. Church upon formation. This definition of the term would imply that the estate tax should be levied against the underlying assets of the partnership disregarding the partnership agreement. The Court disagreed with this inter-

pretation and stated that there is no statutory basis for the Government's contention. The Court found that Mrs. Church did not own the assets that she contributed to the partnership at the time of death, but rather, owned a limited partnership interest. Therefore, the estate tax should be imposed on the value of the limited partnership interest.

Disregard partnership agreement

The Government also asserted that with regard to IRC § 2703 the partnership agreement should be disregarded. Under IRC § 2703, certain rights and restrictions of business agreements may be disregarded for valuation purposes unless three criteria are met:

1. The partnership must be a bona fide business arrangement.
2. The partnership interest cannot be a device to transfer ownership to members of the decedent's family for less than adequate consideration.
3. The terms of the agreement must be comparable to similar arrangements entered into by persons in arm's length transactions.

The taxpayer introduced testimony from a prominent tax attorney, **Charles Hornberger**, who testified that the restrictions in the agreement were similar to those in arm's length transactions. The Court's rejection of the use of IRC § 2703 was clear:

No case supports the Government's position, and nothing in legislative history, or the regulations adopted by the IRS itself, convince this Court to read into Section 2703 something that is not there. By its very nature, a partnership is voluntary association of those who wish to engage in business together, and upon whom the law imposes fiduciary duties. Term restrictions, or those on the sale or assignment of a partnership interest that preclude partnership status for a buyer, are part and parcel of the property interest created by state law. These are not the agreements or restrictions Congress intended to reach in passing IRC 2703. Reviewing the legislative his-

* Bruce A. Johnson, ASA, was the valuation expert for the taxpayer in this case. Mr. Johnson is a shareholder in the business valuation firm of Munroe, Park & Johnson, Inc., in San Antonio, Texas, and he is a member of the International Board of Examiners of the American Society of Appraisers.

Continued to next page...

LEGAL & COURT CASE UPDATE

Taxpayer victory on FLP recognition

... continued from previous page

tory, and construing IRC 2703 with its companion statute IRC 2704, it is clear that the former was intended to deal with below-market buy-sell agreements and options that artificially depress the fair market value of property subject to tax, and are not inherent components of the property interest itself.

No economic substance

The Government contended that the partnership was a "sham" transaction and did not have economic substance. The Court rejected this argument by examining the facts supporting the formation of the partnership. First, Mrs. Church died unexpectedly of a cardiopulmonary collapse. The taxpayer presented evidence regarding the health of Mrs. Church by her doctor, Dr. Stephen Cohen. The Court found that the cause and timing of Mrs. Church's death was irrelevant to the case. Secondly, the Court found that the partnership had a bona fide business purpose, which was a desire to preserve the family ranching enterprise for the Church descendants. The marketable securities of the

partnership were intended to provide liquidity for working capital since the ranch had endured several years of low profitability due to drought conditions. Furthermore, a member of the Drake family had in the past moved onto the property and claimed it as a homestead. The partnership intended to use the marketable securities to purchase his interest in the ranch property.

Valuation of limited partnership interest

With regard to the value of the limited partnership interest, the Government did not present an opposing expert's report and was unable to invalidate the methodology employed by the taxpayer's expert to value Mrs. Church's limited partnership interest. A brief summary of the appraisal is as follows.

Mrs. Church's limited partnership interest was valued as of the alternative valuation date using the income and market approaches. Because a limited partner cannot control the liquidation of the underlying assets of the partnership, the cost approach was not used. The methodology employed to value the limited partnership interest is explained in chapter 14 of PPC's *Guide to Business Valuation*.

For the income approach, the expected revenue and expenses for the real estate prop-

erty were forecast along with the expected income from the marketable securities. The cash flow available for distribution was discounted to present value using a weighted average discount rate that reflected the risk of the assets in the partnership. A value was estimated using the market approach, using closed end funds and real estate limited partnerships from *Partnership Profiles*. The two values were reconciled to determine a marketable, noncontrolling value. A discount for lack of marketability was applied to provide an estimated yield of approximately 15.0% to the limited partner. This return was deemed reasonable in comparison to alternative investments to compensate the investor for the illiquidity and the additional risks associated with ownership of the privately held interest. The resulting value of \$617,591 equated to a 57.6% discount from the partnership's net asset value.

The Government attempted to invalidate the partnership agreement by almost every means possible. However, the Court found that when the facts of the case can be supported by law and the business purpose can be reasonably explained, a limited partnership is a valid entity that cannot be disregarded for estate tax purposes. **BVU**

INTERNAL REVENUE CODE SECTION 2703

Certain rights and restrictions disregarded.

(a) General rule. For purposes of this subtitle, the value of any property shall be determined without regard to—

- (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or
- (2) any restriction on the right to sell or use such property.

(b) Exceptions. Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

- (1) It is a bona fide business arrangement.
- (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
- (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

ESTATE TAX

Equipment company valuation turns on asset- and earnings-based values

Dunn v. Commissioner, T.C. Memo 2000-12, 79 T.C.M. (CCH) 1337 (Jan. 12, 2000).
Judge Gale.

Key words:

Fair market value, Heavy equipment rentals, Asset-based method, Earnings-based method, Net asset value, Discount for lack of marketability, Discount for lack of super-majority control, Capitalized net cash flow, Liquidation value, Cyclical business, Built-in capital gains tax

The fair market value of 492,610 shares of stock in **Dunn Equipment, Inc.** is in dispute in this case. The IRS found a deficiency of \$1,100,000 in petitioner's federal estate tax return, where the shares were valued at \$3.32 per share. Decedent owned 62.96% of the outstanding shares in Dunn Equipment, which was in the business of renting heavy equipment like cranes and air compressors and providing operators of that equipment. Decedent was one of three executive offic-

ers of the company. Dunn Equipment had a good reputation and held a substantial share of the heavy equipment rental market. However, Dunn Equipment had not increased its rental rates in over ten years because of the market competition, and it spent an average of \$2 million per year for equipment replacement. As of the valuation date (date of death) there were no public market or recent private transactions in Dunn Equipment stock.

Petitioner argued that the value of decedent's interest should not exceed \$1,582,185 based on a 50-50 weighting of asset- and earnings-based values. The IRS argued that the value of the shares is \$4,430,238, which equals 62.96% of Dunn equipment's net asset value minus a discount for lack of marketability and lack of super-majority control.

Continued to next page...