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IRS Proposes Writing Kohler Out of the Law

Last March the Internal Revenue Service announced its decision not to acquiesce in the Tax Court's ruling in *Kohler v. Commissioner*. (See the Action on Decision published in the Internal Revenue Bulletin, 2008-9, March 3, 2008.) A brief footnote elaborated:

Nonacquiescence relating to whether I.R.C. section 2032 allows a discount for transfer restrictions and a purchase option imposed on closely-held corporate stock pursuant to a post-death tax-free reorganization in determining the fair market value of the decedent's stock on the alternate valuation date.

Section 2032 generally permits an estate to elect an alternate valuation date, six months after the date of a decedent's death. If the overall value of the estate has decreased during that time, the estate can reduce its tax burden. The IRS expanded on its decision in April, when it published new rules in the Federal Register that would permit estates to elect the alternate valuation date (per §2032(a) and Form 706) only when market conditions and not "other post death events" have reduced the gross value of the estate. (For the complete proposed regulations, see <http://edocket.access.gpo.gov/2008/pdf/E8-9025.pdf>.)

Congress enacted the predecessor to Section 2032 after the Depression, when market values decreased so materially from the date of death to the date of distribution that at times, "many estates were almost obliterated by the necessity of paying a tax," the IRS says. Since then, two cases have interpreted the provision differently. In 1972, a federal district court in California excluded any reduction in an estate's value that resulted from the trustee's "voluntary acts." But in 2006, the



Kohler decision permitted the Tax Court to consider a post-death reorganization of the company that resulted in discounts (due to transfer restrictions) on the value of the estate's stock holdings. To resolve the apparent conflict, the IRS now seeks to amend Section 2032(f) so that only "market conditions" will make the alternate valuation date available:

The term market conditions is defined as events outside of the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued. Changes in value due to mere lapse of time or to other post-death events other than market conditions will be ignored in determining the value of decedent's gross estate under the alternate valuation method.

Would the Kohler outcome be any different?

The Tax Court found several legitimate reasons for the Kohler Company's reorganization, including removing outside shareholders and keeping the longstanding

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private company within family control. The estate—which owned 12.5% of the voting stock, “could not have blocked or approved the reorganization on its own,” the court said. Nor did it have the power to change management, the board of directors, or the company’s articles of incorporation. While the Tax Court did not specifically find that the reorganization was a corporate event—if it was beyond the estate’s control, then would the market value of the estate’s shares necessarily reflect the resulting transfer restrictions, no matter the valuation date? For example, the date of death would reflect the expectation that the reorganization would take place, while the alternate valuation date, six months later, would reflect the actual restructuring.

Until this matter is resolved definitively, however, attorneys can expect continued debate—and litigation—regarding what comprise market conditions and how these forces affect valuation during the alternate valuation period.

Finally, a Tax Court Considers a ‘Good Facts’ Family Limited Partnership

Estate of Mirowski v. Comm’r, T.C. Memo. 2008-74 (March 26, 2008)

After a recent string of “bad facts” cases dealing with family limited partnerships (FLPs) and limited liability companies (LLCs), the U.S. Tax Court delivered some relief to taxpayers with this new case. *Mirowski* also provides a potential “roadmap” for good planning, funding, and presenting an FLP or similar entity, such as a limited liability company, should it meet an IRS challenge under IRC §2036(a).

Long-term planning, sudden death

Mrs. Mirowski’s husband, a physician, helped develop a patented medical device in the 1960s, which became enormously profitable after his death in 1990. Continuing a long history of family and charitable giving, Mrs. Mirowski retained a majority (51.09%) interest in the patent and licensing agreements, but gifted



the remaining interest into three irrevocable trusts for each of her daughters.

In August 2001, and with the assistance of her financial advisors, she executed the *Mirowski Family Ventures (MFV)*, a limited liability company, funding it within a week with more than \$60 million in assets, including the 52% interest in medical patents. In early September, she gave each of her daughters’ trusts a 16% member interest in MFV, for a total of 48%. The MFV operating agreements designated Mrs. Mirowski as general manager, but a sale or other transfer of the company required approval of all members. Although she made no arrangements for how the daughters would pay the substantial gift tax liability that would result from their MFV membership, Mrs. Mirowski retained substantial personal assets (over \$7.5 million) from which she could have provided payments. Four days after funding MFV, however—and quite suddenly, Mrs. Mirowski died from complications of her diabetes.

Family management is key

Mrs. Mirowski’s estate paid over \$14.1 million in estate taxes—but on audit and pursuant to §2036, the IRS determined that the estate owed an additional \$14.2 million in taxes, based on the inclusion of all Mrs. Mirowski’s transfers to MFV. The IRS tried to compare MFV to prior “bad facts” cases in which the Tax Court rejected an FLP or similar entity based on improper or belated funding, failure to observe

partnership structure and management procedures, and other “badges” of non-business purpose. In these cases, the FLP often had little use beyond an estate planning (and tax avoidance) device.

By contrast, the estate distinguished this case by its comparatively “good facts.” For instance, even though Mrs. Mirowski died within days of funding MFV, her death was entirely unexpected. Although she realized that forming MFV could result in potential tax benefits, her primary motivations were: (1) Joint management of the family's assets by her daughters and eventually her grandchildren; (2) pooling the assets to allow for investment opportunities that would not be available if she made separate gifts to each of her daughters or their trusts; (3) providing additional protection from potential creditors for the interests in the family's assets; and (4) providing for each of her daughters and ultimately her grandchildren on an equal basis.

The Tax Court agreed with the estate, finding that MFV had “real and significant non-tax business purposes” that met the §2036(a) criteria to apply the “bona fide sale” exception to the transfers. In fact, based on the record, the mother's wish for her daughters to remain “closely knit and be jointly involved” in managing the family assets was the most significant nontax purpose and “standing alone,” the court held, was sufficient to qualify for the §2036(a) exception.

The IRS claimed that Mrs. Mirowski had failed to retain sufficient assets outside of MFV to support her own expenses as well as her daughters' substantial gift tax liability. But the court found that she could have paid this expense from her retention of over \$7.5 million in assets or from the anticipated MFV distributions. At no time before her death, the court said, did the members of MFV have any agreement, express or implied, to fund the liability with MFV assets.

Finally, even though Mrs. Mirowski was the general manager of MFV, her powers and discretion were subject to the operating agreement—including its requirement of other members' approval for major transactions. The court found no agreement, express or implied, that by her position she retained a right or interest into the respective 16% interests in MFV that she gave to her daughters' trusts.

Appraiser Provides Accurate Measure of Debt-Ridden CPA Firm in Divorce

Scott v. Scott, 2007 Va. App. LEXIS 454 (December 18, 2007)

During the Scotts' marriage, the husband was a CPA and one of three shareholders in his accounting firm. Per an informal agreement among the three shareholders, they each received an equal or 33% share of the firm's profits, regardless of his stakeholder interest. By the time the Scotts went to trial over their divorce, the husband owned 20% of the shares. These two disparate values—ownership vs. profit-sharing—formed the crux of this case, which the Virginia Court of Appeals declined to publish, but which exemplifies how good work by an accredited appraiser can make the difference in litigating the value of what appears to have been a badly run accounting business.

A corporation in name only

For example, during the two years prior to trial, the husband's CPA firm had consistently failed to bill its clients. Although annually registered as a corporation, the firm had no stock book, no meetings of the board of directors, and no corporate minutes. None of the stockholders could say whether they had received stock certificates, and only the husband produced one for 18.66 shares dated more than ten years before the divorce.

The husband declined to offer a business valuation expert at trial, relying on his own testimony and that of the other firm shareholders. They pointed to the buy-sell provisions of the shareholder agreement, which entitled an owner, upon departure or dissolution, to receive the increase in receivables and work-in-process from the time of acquiring the stock through departure, multiplied by his ownership interest. Because of the firm's accrued debts, all of the shareholders (and even the wife's expert) agreed that the husband would receive “no money” under the shareholder agreement.

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The wife offered a CPA and qualified business valuation expert, who valued the CPA firm after reviewing the employment and shareholder agreements, corporate tax returns, accounts receivables, salary schedules, and shareholders' meetings. Using a capitalization of earnings method, he valued the husband's 20% share between \$83,500 and \$87,200. In addition, the expert valued the husband's 33% profit interest between \$139,200 and \$145,200.

The trial court declined to value the CPA firm using the 20% shareholder interest, because—in essence—“no one knows what the stock amounts are.” Given the company’s failure to recognize corporate formalities since its original stock agreement, the trial court found the firm was a “corporation in name only.” Accordingly, it adopted the wife's expert's 33% ownership figure and valued the husband's share at \$145,200. The husband appealed both aspects of the decision.

Appellate court seeks intrinsic value

The husband argued that the trial court failed to consider the firm's large debts and its value per the buy-sell agreement, which would be zero. The Court of Appeals found these unpersuasive, noting that the

wife's expert specifically deducted the firm's debts in reaching his valuations. Further, any decision based on what the husband might receive upon leaving was “too speculative.” Indeed, the husband testified that he planned to stay, due to a non-competition agreement. The court also noted that, absent evidence of an intended sale or departure, discounts did not apply to this intrinsic value.

Next, the husband claimed that even if \$145,000 was an accurate valuation, the trial court's assignment of a 33% ownership interest (rather than 20% shareholder interest) was incorrect. The appellate court reiterated that while on paper the husband may have only owned 20% of the business, in reality the three owners equally shared the firm's profits and losses. Under these circumstances, “it was acceptable for the trial court to treat [the firm] as a partnership rather than as a corporation.” The number of the husband's shares was not the best measure of the firm's intrinsic value—which, the court stressed, was the appropriate measure when valuing an asset for equitable distribution purposes.

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