MPI's Comments on Various Tax Court Decisions

Estate of Elkins v. Commissioner, 140 T.C. No. 5. Filed March 11, 2013.

The decedent, James Elkins, and his children owned fractional interests in various works of art. Their co-tenancy agreement required the unanimous consent of all co-tenants to sell any items of the art. Judge Halpern said this restriction on sale was equivalent to a waiver of the right to partition and should be disregarded under Code Section 2703. He reduced the estate's 44.75% discount in valuing the art to 10% but his discount analysis does not consider the impact, if any, of Section 2703. In fact, his 10% is attributed to imagined behavior of the children acting together to acquire the art from a hypothetical buyer and paying close to pro rata fair market value "given their undisputed financial resources to do so." In our view, his treatment of the children as particular buyers is a clear departure from the hypothetical willing buyer/willing seller valuation standard and reminds us of his decision in *Holman** where a withdrawing member of a family investment LLC would be accommodated by the family at a favorable price.

COMMENT: The Elkins decision involves significant tax dollars and should be appealed to the Fifth Circuit. It will not change the way MPI approaches asset-based valuations.

Keller v. U.S., No. 10-41311 (5th Cir. Sept. 25, 2012).

Rayford and Lane Keller, CPAs, advised their client, Maude Williams, to form a Texas limited partnership into which she would contribute a $250 million bond portfolio. Maude signed the FLP agreement and the partnership was registered with the Texas Secretary of State but she died before the partnership was funded. Believing failure to transfer the bonds to the partnership aborted the entire plan, the estate's representatives made an estate tax payment which assumed non-existence of the partnership and therefore no valuation discounts. One year later Lane Keller attended a CLE seminar and learned about a case** where a Texas partnership was recognized despite defects in its attempted formation two days before death. Emboldened, the estate filed a claim for refund and cured the record by retroactively

(a) contributing the bonds to the partnership and (b) borrowing from the partnership in order to pay estate taxes.

Much to the disappointment of the IRS, the U.S. District Court's decision*** recognized Maude's partnership and its discounted value. In addition, the Court approved the estate's deduction of interest on its loan from the partnership. The IRS appealed.

The Fifth Circuit has affirmed:

- Under Texas case law, intent determines ownership of partnership property. It was clear from the facts that Maude wanted the bonds to be in the partnership.
- The estate's other assets were illiquid ($110 million ranch land and mineral interests) so it borrowed from the partnership. Interest on the loan was a "necessarily incurred administration expense" and thereby deductible.

COMMENT: Total valuation discount was 47.5%!

* *Holman v. Commissioner*, T.C. No. 12 (2008), aff'd 105 AFTR 2d ¶ 2010-721 (8th Cir. 2010).
** *Church v. U.S.*, 85 AFTR 2d 2000-804 (W.D. Tex. 2000), aff'd 268 F.3d 1063 (5th Cir. 2001).
*** *Keller v. U.S.*, 106 AFTR 2d 2010-XXXX (S.D. Tex. September 14, 2009).

Wandry v. Commissioner, T.C. Memo. 2012-88. Filed March 26, 2012.

The donor used a formula ("adjustment") clause in making dollar amount gifts of family LLC units to her children and grandchildren:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:
>
> *(List of donees and their respective gift amounts not shown)*
>
> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date.
>
> Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-

> party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

Judge Haines rejected incomplete gift and "contrary to public policy" arguments by the IRS and approved a reduction in the number of units transferred due to an increase in their value by the IRS. Previous cases* have involved clauses which reallocated the transferred shares between the donor and charity in the event of an increase in value.

The IRS announced its not-acquiescence in *Wandry* on November 13, 2012.

Ludwick v. Commissioner, T.C. Memo 2010-104. Filed May 10, 2010.

Andrew and Worth Ludwick transferred one-half undivided interests in their Hawaii residence to separate QPRTs and deducted 30% discounts in valuing the transfers for gift tax purposes. The IRS used an 11% discount in valuing the transfers at trial, having originally been at 15%. Judge Halpern rejected transactional data analyses of valuation experts for both sides, preferring an approach whereby fair market value was the weighted function of the cost, time and likelihood of a direct sale versus a forced sale in a contested partition proceeding. Since the Judge was not convinced partition was necessary, he gave it only a 10% weight in his present value calculation, resulting in an overall 17% discount.

COMMENT: The opinion does not mention the Ludwicks' tenancy in common agreement although its existence was stipulated by the parties. We can only guess what part it played in the decision to assign a 10% weight to partition. The agreement prohibits partition while Hawaii law allows it. It is hard to believe a hypothetical buyer could count on the other 50% owner's cooperation 90% of the time.

The 10% rate of return Judge Halpern said a hypothetical buyer would demand seems too low. The Ludwicks' 30% rate was considered unsubstantiated. A rigorous determination of the rate of return should be a part of every report.

The *Ludwick* decision will not affect our valuation approach. If a right to partition exists, the necessary present value analysis will be performed to yield an appropriate discount from the ratable share of the property's value. We will also continue to analyze an undivided interest as an illiquid minority interest and support discounts for lack of control and lack of marketability. The two results will be compared and the methodology best representing where a hypothetical willing buyer and willing seller would likely come to terms will be considered determinative of fair market value.

* *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006); *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280. See also *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) where the estate's sole beneficiary could disclaim any IRS increase in the gross estate's value in favor of charity.

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