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Family Limited Partnerships Lessons from the Tax Court on Business Purpose

We have observed the increasing popularity of Family Limited Partnerships ("FLPs") in the estate planning process. A recent Tax Court case, *ACM Partnership*, (T.C. Memo 1997-115) focuses on the importance of business purpose in tax planning.

ACM Partnership was not a Family Limited Partnership. However, like many family partnerships, it was developed in order to minimize taxes. The case involves an elaborate plan to shelter capital gains from income taxes, involving a domestic corporation, an offshore partnership, the purchase and sale of LIBOR Notes and a contingent installment sale transaction. According to the Court, the transactions and returns connected thereto were the result of a carefully crafted and faithfully executed sequence of sophisticated and costly financial maneuvers that left little to chance or market opportunities. The Partnership used the legitimate contingent payment sale provisions of sec. 15a. 453-1 [c], Temporary Income Tax Regs., 46 Fed. Reg. 10711 (Feb. 4, 1981), a "section 453 investment strategy." The strategy created approximately \$100 million of capital losses for the Company, a domestic corporation, (thereby sheltering capital gains already incurred), and corresponding capital gains for a foreign corporation that was not subject to U.S. tax. While the convoluted details of the transaction are beyond the scope of this article, the point is that the Court disregarded the section 453 investment strategy for Federal income tax purposes because it lacked economic substance.

The Court addressed several issues which go to the point of economic substance. The Partnership purported to show that it was rationally designed to address genuine liability management needs, and had practical effects wholly apart from their tax consequences. Although not finding any economic substance in the section 453 investment strategy, through a series of very detailed financial analyses, the Court was convinced

(Continued on Page 2)

In the formation of a FLP, business purpose should not be a brief afterthought description of what the Partnership will do, but rather should reasonably describe why its operations can achieve the economic benefits sought by the Partners

CASE LAW UPDATE

Bosca (Petitioner) v. Commissioner (Respondent)

No. 14997-94, 1501-94 (U.S. Tax Court, July 8, 1998.) Judge Whalen.

This recent consolidated case illustrates the complications that evolve from the exchange of types of common stock in a privately held corporation and the resultant valuation of the transaction.

At issue was whether or not the exchange was considered a "gift" according to Internal Revenue Code (and therefore subject to gift and estate taxes); and if so, what premium should be applied to that gift depending on the block size of exchanged shares.

(Continued on Page 3)

IN THIS ISSUE

**Family Limited Partnerships
Lessons from the Tax Court
on Business Purpose 1**

**Case Law Update
Bosca v. Commissioner 1**

**The Difference Between
a Valuation Expert and
an Industry Expert 2**

Family Limited Partnerships

(Continued from Page 1)

that tax avoidance was the reason for the Partnership transactions. “We do not suggest that a taxpayer refrain from using the tax laws to the taxpayer’s advantage. In this case, however, the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws.”

In the seminal case of *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), the Court recognized an individual’s right to decrease taxes in any way permitted by law. As held by the Court, however, this right is not absolute. The Court held that a reorganization that met the literal requirements of the Code would not be respected for Federal income tax purposes if it had no business or corporate purpose, but was a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character.

In the case of *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), affg. 44 T.C. 284 (1965), the Court of Appeals applied the doctrine of economic substance. In that case, Mrs. Goldstein won the Irish Sweepstakes. In an attempt to shelter her winnings from tax, she borrowed from two banks and invested the money in Treasury notes. Her financial advisors estimated that these transactions would produce a pretax loss, but a substantial after tax gain.

The Appeals Court sustained the disallowance of the interest deductions, stressing that Mrs. Goldstein’s purpose in entering into the loan transaction was not to derive economic gain or im-

prove her beneficial interest, but was solely an attempt to obtain an interest deduction as an offset to the sweepstakes winnings. The loan arrangements did not have purpose, substance or utility apart from the anticipated tax consequences. In short, the strategy was not consistent with rational economic behavior in the absence of the expected tax benefits.

From the Court’s perspective, whether a transaction has economic substance is a factual determination. Key to this determination is that the transaction must be rationally related to a useful non tax purpose that is plausible in light of the taxpayer’s economic situation and intentions. Both the utility of

The detail of analysis included in the case implies that the realization of valuation discounts in FLP valuations lies in the quality of the analysis presented to the Court

the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the non tax benefits would be at least commensurate with the transaction costs.

The Tax Court judge on the ACM Partnership case was Judge David Laro. Judge Laro is, at least among business appraisers, one of the best-known judges on the U.S. Tax Court, and has written some widely read and discussed opinions addressing issues fundamental to business valuation. The detail of analysis included in the case implies that the realization of valuation discounts in FLP valuations lies in the quality of the analysis presented to the

Court. Part of that analysis includes the legitimate business purpose for the formation of FLPs, which must have purpose, substance or utility apart from the anticipated tax consequence to be respected by the Court.

In the formation of a FLP, business purpose should not be a brief afterthought description of what the Partnership will do, but rather should reasonably describe why its operations can achieve the economic benefits sought by the Partners. Once in place, of course, it is important to follow through in practice with those business purposes, to be able to show, ultimately with the benefit of hindsight (which is when the tax auditor will see it), why the operations of the Partnership met the criteria of economic substance. ♦

The Difference Between a Valuation Expert and an Industry Expert

And Why It's Important

What kind of expert do you need when your company requires valuation services — a valuation expert or an industry expert? You might be asking yourself, “What’s the difference?” Often, there is a big difference, one that is important for you to know and understand.

An *industry expert* is that expert with intimate knowledge of an industry but not necessarily of valuation techniques. Many industry experts focus only on transaction-type valuations and know very little about independent valuation methodologies, documentation requirements, case law and valuation literature, all of which are critical to developing a reasoned and reasonable valuation conclusion.

(Continued on Page 4, Column 2)

Case Law Update

(Continued from Page 1)

In a May 25, 1990 recapitalization of his company, Mr. Bosca exchanged his 402.5 shares of voting common stock (50% of the total) with the corporation for 402.5 shares of Class B nonvoting stock.

Mrs. Bosca exchanged her 36.34% share of voting common stock for the same and subsequently transferred 100% of those shares to her husband. The two sons held the remaining 13.66% outstanding voting common shares and exchanged those with the corporation for Class A voting common stock. The corporation canceled the voting stock it received in the transaction and thus the transaction gave 100% of the voting rights to Mr. Bosca's two sons.

Following Mr. Bosca's death in the latter part of 1990, the estate filed Form 709 (U.S. Gift Tax Return) for the 1990 calendar year. As an addendum to this document, the estate declared that under the facts and circumstances of the recapitalization, it was their position that the recapitalization did not result in a gift to the corporation by Mr. Bosca.

	Pre-Recapitalization		Post-Recapitalization			
	Voting Common	Percent of Total	Class A Voting	Percent of Total	Class B Nonvoting	Percent of Total
Mario Bosca	402.5	50.0%	0.0	0.0%	785.0	100.0%
Marie Bosca	292.5	36.3%	0.0	0.0%	0.0	0.0%
Christopher Bosca	55.0	6.8%	55.0	50.0%	0.0	0.0%
Anothony Bosca	55.0	6.8%	55.0	50.0%	0.0	0.0%
Total	805.0	100.0%	110.0	100.0%	785.0	100.0%

The estate argued that after the recapitalization, the only consequent effect was the loss of Mr. Bosca's voting rights; that the exchange had no effect on the total assets, liability, or owners' equity of the corporation and thus no gift was made, and no value was transferred to the corporation. Therefore, the estate should not be liable for any resultant gift taxes as a consequence of this transaction.

The Tax Court effectively rejected the estate's claim that no value was transferred to the corporation (and accordingly to the two sons) in the transaction as a result of recapitalization. The Tax Court stated that "a transfer of property by an individual to a corporation for less than adequate and full consideration in money or money's worth generally represents gifts by the individual to the shareholders of the corporation to the extent

of each shareholder's proportionate interest in the corporation." (*Kincaid v. United States*, 682 F.2d 1220, 1224, 1226 [5th Circuit 1982].) Accordingly, the transfer of shares was deemed

a gift pursuant to IRC 2512(b).

If property is so transferred, section 2512 (b) provides that the excess of the value of the property over the consideration received "shall be deemed a gift." Because the sons were the recipients of the gift of Class A voting common stock, the ensuing matter be-

Effectively the issue was a determination of the size of an applicable premium to the value of the nonvoting common stock

came whether the stock that was transferred to the company should have been valued as a single block of 50% or as two blocks of 25%, one block to each son.

Since the transaction constituted a taxable gift, the Tax Court was left to decide the value of that gift. The Respondent argued that the stock exchanged was given as a single block of shares and should be valued accordingly. Tax Court dissented with the Commissioner, noting that "such an approach violates the principle that separate gifts should be valued separately." (*Standish v. Commissioner*, 8 T.C. 1204, 1209 [1947]; *Calder v. Commission*, 85 T.C. 713, 720-721 [1985].)

(Continued on Page 4, Column 1)

	Position of Respondent	Position of Petitioner
Value of a share of voting stock before the recapitalization if held as part of a 50% block*	\$11,827	
Value of a share of voting stock before the recapitalization if held as part of a 25% block*		\$9,671
Value of a share of Class B nonvoting common stock after the recapitalization if held as part of either a 50% or a 25% block*	\$9,415	\$9,415
Difference	\$2,412	\$256
Number of shares	402.5	402.5
Aggregate value of gifts made by Mr. Bosca to his sons	\$970,830	\$103,040
Difference in gift valuation	\$867,790	

*Values stipulated by both parties

Case Law Update

(Continued from Page 3)

The Tax Court concluded that the indirect “gift” of voting rights to the two sons was made separately and therefore should be valued at two separate blocks of 25% each.

Effectively the issue was a determination of the size of an applicable premium to the value of the nonvoting common stock. Had the stock been valued as a single block per the position of the Respondent, a 25.6% premium would have been applied to the value of the nonvoting common stock, and thus would have resulted in a greater tax liability. Instead, the Tax Court ruled the stocks were to be treated as a gift of two separate blocks of 25% each and a premium of 2.7% should be utilized.

This case covered a number of general concepts that are meaningful in the valuation of a gift of securities in a closely held business interest, but most importantly, at issue was the size of the premium. Unfortunately for business

valuation experts, this Tax Court ruling did not provide any guidance for future valuations of this type of interest as all levels of value (voting controlling, voting minority, and nonvoting) were stipulated by both the Respondent and the Petitioner.

What this case did illustrate was the importance of level-of-value determination and the resultant tax liability. Here the decision led to an aggregate taxable gift valued at \$867,790 less than the Respondent’s position and was therefore subject to significantly less gift tax.

Please call us if you would like to discuss a valuation issue in confidence. ♦

A Valuation Expert vs. An Industry Expert

(Continued from Page 2)

The *valuation expert* is that expert with a general knowledge of many industries, but, more importantly, with specific knowledge of valuation techniques, methodologies and other factors vital to the valuation process. Valuation expertise, like industry

expertise, is learned over years of study and practice.

We believe, not surprisingly, that you should expect your business appraiser to be a valuation expert and have a broad base of industry knowledge. Anything less will probably result in an unsatisfactory valuation result. Appraisal expertise, coupled with

The *valuation expert* is that expert with a general knowledge of many industries, but with specific knowledge of valuation techniques

broad industry knowledge, is the appropriate combination to expect from any business appraiser. Courts are seldom misled by “experts” who know little about valuation when it comes to valuation issues. So, do not be swayed by the industry experts who plan to develop valuation experience at your expense.

Give us a call for more information or to discuss a valuation issue in confidence. ♦

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