



Business Valuation, Forensic Accounting and Litigation News of Substance

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

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Ahern v. Ahern, 2008 Me. LEXIS 1 (January 3, 2008)

Until this case, Maine was one of only three states that had yet to determine whether the enterprise goodwill of a professional practice constitutes marital property. (The other two are Alabama and Georgia.) With this decision, the Maine Supreme Court considered whether it would join the majority rule, which distinguishes the components of goodwill and finds that enterprise goodwill is marital while professional goodwill is not.

Failure to explain components of goodwill

During the Ahern's twenty-one year marriage, the husband was the sole principal of a dental practice. At their divorce trial, the wife's expert assigned the dental practice a fair market value of \$538,000, of which \$184,000 constituted the "hard assets" and approximately \$173,000 constituted goodwill. (According to the court opinion, the appraiser apparently "failed to explain the character of the remaining balance" of more than \$181,000.) The wife's expert averaged earnings of the practice over the previous five years. The practice's earnings figures were influenced by at least one other dentist working in the practice during these years. As to the goodwill component, the expert attributed it to the husband's "reputation and skill," and admitted that to realize its value, the husband would have to sell the practice. By contrast, the husband's expert arrived at a fair market value for the practice of \$366,000. While acknowledging that the practice had goodwill value—the expert did not specify how much of the \$366,000 was goodwill.

The trial court concluded that the hard assets were worth \$116,773. It expressly declined to include the wife's expert's goodwill value of \$173,000, stating that this amount "represented personal goodwill of [the husband] as opposed to any 'enterprise good will.'" Any excess value in the expert's appraisal, after deducting the hard assets and personal goodwill, could be "deemed the value of 'enterprise goodwill,'" the trial court said. But given the lack of supporting evidence or explanation from the appraiser, it could not make that calculation, and the trial judge assigned a total value to the practice of \$116,773. The wife appealed.

Maine stakes a clear position

The Maine Supreme Court recognized that it was among a handful of jurisdictions that have



not specifically addressed how a divorce court should treat the goodwill of a professional practice. The Court referred to the frequently cited *May v. May* (W. Va. 2003), which collects cases from the forty-two states that have addressed the issue and analyzes the three different approaches that the majority states have developed. "Most jurisdictions embrace a framework that distinguishes between 'enterprise' goodwill and 'personal' goodwill," the court said.

Despite its prior failure to specifically address the issue, however, "our prior decisions have implicitly recognized the distinction." For instance, Maine cases found that insurance agencies (as distinct from professional firms) have a transferable, divisible goodwill value, which does not attach to a principal agent or founder. By comparison, other cases recognized that the enhanced earning capacity a professional enjoys due to academic credentials, licenses, experience, and reputation is the "essence of 'personal' goodwill."

"We now adopt the enterprise/personal framework for the purpose of evaluating the goodwill of a professional practice in the context of an equitable distribution of property," the court held. In this case, the experts "unequivocally" testified that the goodwill value of the dental practice resulted from the husband's skill and reputation. "As such, it was not readily transferable or realizable."

Further, neither appraiser treated it as a component of the value of the practice arising from the practice's generally marketable established relationships, name, and business reputation, which are the earmarks of enterprise goodwill. Under these circumstances, the court had "no difficulty" concluding that the personal goodwill value of the husband's dental practice was "not a species of property subject to equitable division." Accordingly, it affirmed the trial court in all respects. □

***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 fund-

ing, 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. □

Can You Take it With You?

Court Revisits Family Limited Partnership Discounts

In the Matter of the Estate of Norman B. Hjersted, 2008 WL 269013 (Kansas) (February 1, 2008)

In deciding the first incarnation of the *Hjersted* case in 2006, the Kansas Court of Appeals held that discounts for lack of marketability and control did not apply to a family limited partnership (FLP), particularly when its purpose was to disinherit Mr. Hjersted's wife of nearly twenty years, to the benefit of his son by a prior marriage. The son appealed to the Kansas Supreme Court.

Discounts create 'illusory layers of ownership'

Prior to his death, Mr. Hjersted created an FLP to hold all the outstanding stock (500 shares) of his closely held company. He became a 96% limited partner in the FLP and a 2% general partner; the remaining 2% belonged to his son. Three years later, Hjersted transferred his 96% limited partnership interest to the son as part gift/part sale. The transaction stipulated that the gift was worth \$675,000, the then-maximum allowable amount without incurring federal income tax. To carve out this gifted portion, an appraiser valued the 500 shares at \$4,500 per share and the company at \$2.25 million. He then subjected the 96% limited partnership interest to combined, layered discounts for lack of marketability and control equaling 32.5%, for a total fair market value of approximately \$1.46 million.

When Mr. Hjersted died a year after the transfer, his wife sought her statutory elective share of the estate. At trial, her valuation expert determined the fair market value of the company's 500 shares as of the transfer date; he was not asked to—nor did he consider—its value “as contained within” the FLP. He valued the company at \$2.66 million, to which he applied a 10% marketability discount. Accordingly, the 96% interest was worth just over \$2.55 million. For the most part, the trial court agreed, and after certain reductions, it valued the wife's elective share at \$1.175 million, and the son appealed.

The appellate court upheld her expert's valuation. Discounts injected too much speculation into the appraisal, the court said, and were inappropriate when the transaction unified ownership into one individual. Moreover, applying discounts could help create “layers of illusory ownership for non-probate transfers...in furtherance of a scheme to disinherit a spouse.”

Supreme court offers 'contours of guidance'

On review, the Supreme Court focused on a fine legal distinction: As a rule, an appellate court “does not weigh conflicting evidence, pass on the credibility of witnesses, or redetermine questions of fact.” But in this case, the appellate court overstepped its bounds. In rejecting the discounts used by the son's appraiser, its analysis revealed a *de novo* review and resulting legal conclusion. However, it did not subject the wife's appraiser and his 10% discount to a similar review:

Consequently, the Court of Appeals' decision ultimately made case-dispositive a valuation that made no pretense of addressing that court's paramount issue: value of the [FLP] interest on [the transfer date].

The trial court found that the FLP was a valid transfer, and rejected the wife's argument that its nature was illusory or for a non-business purpose. Accordingly, the Court of Appeals could not revisit this conflicting evidence and then rely on the purported artificiality of the FLP to conclude that the combined discounts were unnecessary, the Supreme Court held, and reversed the appellate holding. The valuation of the FLP interest was “best left” to the trial court, which would—at a minimum—address the validity of the combined 32.5% discounts in the original appraisal. “We cannot prognosticate all the factors that the court could decide to consider in this value determination,” the court said. At the same time, it offered “some general contours of guidance” regarding the application of lack of marketability and control discounts.

Policy on discounts 'at odds'

For example, tax courts have allowed combined discounts for FLP interests “ranging from 25% to 35% and sometimes even more.” These decisions usually turn on findings of legitimate business and estate planning interests.

At the same time, courts generally do not apply discounts in dissenting shareholder actions, because they penalize minority shareholders while unfairly enriching the majority; and Kansas is among the majority of states to disallow discounts in this context. On remand, the trial court should consider whether the wife's situation was comparable to a minority shareholder and entitled to an undiscounted value, the Supreme Court said.

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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 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. □

Can You Take it With You? Court Revisits Family...

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Likewise, in the probate area, the trial court could find that the FLP represented “legitimate steps toward a legitimate estate planning and business objective.” Or it could find (as it did during the original trial) that the appraisal at the time of the transfer suffered from an “inherent bias,” because it sought to minimize the tax consequences—a purpose inconsistent with that of the spousal elective share.

Finally, the trial court could find parallels in state divorce law, which did not clearly prohibit application of discounts. Overall, the many sides of the debate further supported the district court reconsidering this decision, “so it may continue addressing, if not balancing, competing considerations.” □

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