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VALUATION ISSUES™

Klaris, Thomson & Schroeder, Inc. 2004-1

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UNITED STATES TAX COURT CASE SUMMARY
T.C. MEMO 2002-121
Estate of Morton B. Harper v. Commissioner of Internal Revenue

Judge Nims

John A. Thomson, ASA, MAI

The case involved a family limited partnership known as Harper Family Limited Partnership ("HFLP"). The partnership was formed during January of 1994. At the formation of the partnership, Mr. Harper owned a 99% limited partner interest and his two children owned a one percent general partner interest (Michael, .4% and Lynn, .6%). Mr. Morton Harper died February 1, 1995. Prior to his death, he made two gifts of limited partner interests, one to his son, Michael Harper, of 24% and one to his daughter, Lynn Factor, of 36%. The property (assets) in the Partnership consisted primarily of marketable securities and cash (74.3% of net asset value) and a promissory note (also known as the Marsh note) of $450,000, face value, (25.7% of net asset value).

(1) The court held that the property contributed by the decedent to HFLP is includable in his gross estate pursuant to section 2036(a) of the Internal Revenue Service. (2) The court held further the value of the assets to be included in the gross estate were determined.

> "We find the disregard here for the Partnership form to be equally egregious."

We will address both (1) a legal issue, and (2) the valuation issue which involved the promissory note (Marsh note). We start by summarizing Section 2036 (Transfers with Retained Life Estates):

(A) General Rule–The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by Trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death...

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Regulations likewise explain that the gross estate under Section 2036 include the value of transferred property if the decedent retained the "use, possession, right to the income, or other enjoyment of the 'transferred property'". Sec. 20.2036-1(a)(i), Estate Tax Regs. further quoting from the opinion, "as used in Section 2036(a)(i), the term enjoyment has been described as synonymous with substantial present economic benefit." "Moreover, possession or enjoyment of transferred property is retained for purposes of Section 2036(a)(i) where there is an express or implied understanding to that effect among the parties at the time of the transfer, even if the retained interest is not legally enforceable."

Without getting into the details of how and why the Partners disregarded the Partnership, we quote the opinion, "We find the disregard here for the Partnership form to be equally egregious."

Because the Partners disregarded the Partnership form (eg. not establishing a separate partnership

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(Cont.)

account at the outset of the Partnership), the court concluded the Partnership should be disregarded for valuation purposes, which means there are no discounts for the subject Partnership interests.

Next, we turn to the issue of valuation. Quoting the opinion, "We must ascertain the value of HFLP's underlying portfolio assets, without regard to any claimed discounts attributable to the partnership form."

If the underlying assets had been all marketable securities there would have been no discussion in this opinion regarding valuation. However, in the subject case one of the underlying assets was a promissory note which both experts discounted. Therefore, the discussion on valuation relates to the promissory note. The court concluded its value of the note based on examining how both experts valued the note. The promissory note had a face value of $450,000 with an interest rate of 10% and was collateralized by real estate (a mobile home park).

> **"The lessons of this decision are if you are going to set up a family limited partnership for other than tax consideration you better play by the rules."**

The taxpayer's expert opined that the note should be discounted 33% and concluded the value was $300,000. KTS, the experts for the IRS, concluded the note should be discounted 10% for a value of $405,000. The court concluded the discount should be 12% and the value of the note to be $396,000. In this particular case, the qualifications of the experts, their testimony and their respective approaches to the valuation of the note were important.

The expert for the taxpayer was designated as an ASA in business valuations. The KTS expert was also designated as an ASA in business valuations, but additionally was designated as an MAI in real estate and was a California real estate broker. This became an important issue because the collateral for the note was real estate.

The expert for the taxpayer used what he called a market and income approach. However, at trial he said he relied on the market approach. His market approach consisted of talking with the maker of the note, Mr. Marsh and relying on Mr. Marsh's opinion of what the note should be discounted. The key problem here was Mr. Marsh was not an independent source. His income approach was based on using a 15% discount rate and a present value approach based on when he believed the note might be paid off. The 15% was taken from the note as the default rate on the note. The note, which was originally due April 14, 1992 (the valuation date was February 1, 1995) had been renewed annually for one year extensions and payments were current.

KTS valued the note considering five factors: (1) the collateral securing the note; (2) the existence of guaranties relating to the note and its collateral; (3) the interest rate on the note; (4) previously granted extension of the note's maturity date and the currency of payment; and (5) environmental concerns related to the collateral.

The court went on to state "the persuasiveness of an expert's opinion depends largely upon the disclosed facts on which it is based."

The following comments from the opinion on the analysis by the experts is key to the court's conclusion.

"In our comparison of the foregoing views, we generally found those of Mr. Thomson to be better explained, better supported and more convincing...the level of detail in the report's treatment of individual factors considered enabled us to make adjustements within what was a reasonable framework." "In contrast, Mr. Cronkite's report was highly conclusory and revealed little about the underlying analysis. As a result, we could neither perform any meaningful evaluation nor ascertain that the conclusions were supported by an appropriate foundation. We therefore, found Mr. Cronkite's report unpersuasive and of minimal assistance in the valuation endeavor."

The lessons of this decision are if you are going to set up a family limited partnership for other than tax consideration you better play by the rules. Also, when you submit a valuation report to tax court make sure the reader (the judge) can not only follow what you did, how you did it, but allow him the flexibility to be able to adequately review or work with your conclusions if he thinks it needs some adjustment.

John A. Thomson, ASA, MAI *is a Managing Director with* **KTS, Inc.***, in the Los Angeles Regional office, a Senior Member of the American Society of Appraisers (ASA) and a Member of the Appraisal Institute (MAI). (562) 437-6000 e-mail: jthomson@ktsvaluation.com*

In our next issue we will review and comment on recent United States Tax Court Cases dealing with family limited partnership and known as McCord, Peracchio and Lappo.

10-YEAR ANNIVERSARY

It is hard to believe that it has been over 10 years since KTS was formed. In that time we have grown considerably from our original five employees and two offices. However, we are still dedicated to providing personal service to each of our current customers and to our future customers. We celebrate our 10 years by being grateful for our knowledgeable and dedicated employees and for our numerous customers throughout the country and overseas.

Adding New Faces...

KTS is pleased to announce the addition of ***Michelle C. Matava***, CFA to its St. Louis, Missouri staff.

Ms. Matava was formerly the Director of Valuations at A.G. Edwards & Sons, Inc. in St. Louis, Missouri. Prior to her association with A.G. Edwards & Sons, Inc. Ms. Matava was a financial manager for Arthur Andersen's Valuation Service Group.

Ms. Matava specializes in the valuation of capital stock of closely-held companies in a variety of industries including transportation, industrial, energy, healthcare, retail and manufacturing for numerous purposes including transaction planning, taxation planning and reporting requirements, employee ownership, litigation support and dispute resolution, strategic planning and fiduciary advice, and financial consulting. In addition, Ms. Matava has extensive experience in the valuation and remaining useful life analyses of various intangible assets and intellectual properties.

The St. Louis office of KTS is also pleased to announce that ***Luke A. Waller***, Senior Valuation Consultant, has earned the ***Accredited Senior Appraiser*** (ASA) designation in Business Valuation by the American Society of Appraisers. In addition, Luke was recently installed as the president of the St. Louis Chapter of the American Society of Appraisers. Join us in congratulating Mr. Waller on these achievements.

Going New Places

Klaris, Thomson & Schroeder, Inc. has also made two location changes.

We are pleased to announce that with the continued growth and expansion of our firm, our Los Angeles area office has relocated to a larger facility in downtown Long Beach, California.

The new address of our Long Beach office is:

330 Golden Shore Drive, Suite 200
Long Beach, California 90802
The new phone and fax numbers are:
Phone: (562) 437-6000
Fax: (562) 437-6180

In addition to the expansion and relocation of the Long Beach office, our Philadelphia office has also relocated.

The new address of our Philadelphia area office is:

145 Rabbit Run Road
Sewell, New Jersey 08080
The new phone and fax numbers are:
Phone: (856) 256-1950
Fax (856) 256-1975

KTS CALENDAR

RECENT AND UPCOMING SEMINARS AND SPEAKING ENGAGEMENTS

9/5/03 Presentation—Focused Investments Group, Belleville, IL.—"Business Valuation."

9/10/03 Presentation—St. Louis Business Valuation Roundtable, St. Louis, MO.—"Going Private."

9/25/03 Presentation—NACVA, St. Louis, MO.—"SFAS 141, 142 & 144."

10/8/03 Presentation—Center for Emerging Technologies, St. Louis, MO.—"Intellectual Property Valuation."

3/12/04 Presentation—St. Louis Buisness Valuation Roundtable, St. Louis, MO.—"Discussion of United States Tax Court Case Between the Estate of Mildred Green v. Commissioner of Internal Revenue Service."

KTS RECENT ENGAGEMENTS

* Valuation of a midwest bank holding company for dissenting shareholders rights purpose.
* Valuation of midwest auto dealership for a potential sale of the company.
* Valuation of company owning and operating convenience stores and wholesaling petroleum products in the midwest for estate tax purposes.
* Valuation of a material handling equipment manufacturing company for estate or corporate planning purposes.
* Valuation of a jet engine and aircraft ground support equipment manufacturing company for estate or corporate planning purposes.

KLARIS, THOMSON & SCHROEDER, INC.

is a full service valuation and consulting company specializing in business valuations, intangible asset valuations, financial consulting, expert testimony and litigation support. In addition, we also perform real estate valuations, machinery and equipment valuations, and international transfer pricing analyses.

For more information or a free valuation seminar for your firm or professional group, please e-mail your request to info@ktsvaluation.com.

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Valuation Issues

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Quarterly Quote:

"When you are making a success of something it's not work—it's a way of life."
- Andy Granatelli

For more information or for a free valuation seminar for your firm or professional group, please call Marie Schroeder or Mary Sumoski at (314) 739-1000, or e-mail your request to info@ktsvaluation.com.

P.O. Box 515118
St. Louis, MO. 63151