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THE IMPORTANCE OF A SECOND OR CONCURRING APPRAISAL IN PERSUADING THE IRS TO VIEW A FAMILY TRANSACTION AS ONE THAT IS EQUIVALENT TO AN "ARMS' LENGTH" TRANSACTION

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One of the most difficult and troublesome issues facing families of closely held businesses is structuring transactions which will survive challenges by the Internal Revenue Service ("IRS"). Unfortunately, many business transactions between related parties are challenged because the IRS presumes that related party transactions are inherently non arms'-length and are intended to confer an economic benefit on one of the parties. Oftentimes, an appraiser retained by the IRS, determines values different than those determined by a taxpayer's appraiser, with the result that a taxpayer may be exposed to substantial additional income, gift or estate tax obligations. Yet in transactions between unrelated parties, no adverse tax consequences generally result from disparate values.

> **"Unfortunately, many business transactions between related parties are challenged because the IRS presumes that related party transactions are inherently non arms'-length..."**

Thus, the fair market value of an asset may vary substantially based on the perceptions and expectations of the unrelated parties. Art auctions and competing tender offers are examples where unrelated parties often view the fair market value of objects and assets through different lenses, resulting in materially different values. However, the IRS generally does not intervene itself in unrelated party transactions notwithstanding the fact that if the IRS engaged its own appraiser the value which such appraiser may determine could be substantially different from the value agreed to by the unrelated parties.

Thus, the question arises as to whether it is possible for related parties to avail themselves of arms'-length status and thereby avoid the imposition of income, gift or estate taxes where the value determined by its appraiser differs from that of the IRS appraiser. A recent case decided by the Tax Court, Cox Enterprises Inc. & Subs. V. Commissioner, 97 TCM 1767 (2009), may offer some guidance in this area. The Cox Enterprises case involved an income tax controversy[1] and focused on the intent of related parties to achieve an arms'-length transaction.

The transaction in the aforementioned case concerned the formation, in 1993, of KTVU Partnership by KTVU, Inc. a wholly-owned subsidiary of Cox Enterprises Inc. ("CEI"). KTVU, Inc. transferred the assets of Television Station KTVU (a Fox affiliate in San Francisco, California) to KTVU partnership in

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exchange for a controlling interest in the partnership. Cox Family members, substantially all of whom were the children and the grandchildren of the individuals who were the beneficial owners and the Trustees of trusts (the "Shareholder's Trusts") holding approximately 98% of the Stock of CEI, contributed cash to KTVU partnership in exchange for a minority partnership interest. The IRS, based on an appraisal report of it's expert determined that the fair market value of the KTVU station assets transferred by KTVU, Inc. to KTVU Partnership was $300 million and the fair market value of the partnership interest received by KTVU, Inc. in the exchange was only $239.5 million and this 20% difference, namely, $60.5 million, resulted in a constructive distribution by CEI of appreciated property to its shareholders, taxable under Section 311(b). Because of the identity of the interests between the beneficiaries of the Shareholder Trusts and members of the family partnerships, the IRS, in a companion case asserted that the Trustees and life beneficiaries of the Shareholder Trusts, who were the parents and grandparents of the Cox Family Members were in receipt of a constructive dividend in the amount of $60.5 million.[2]

Prior to the organization of KTVU Partnership, CEI, with the consent of the Cox Family Members, engaged a national accounting firm (which firm was not CEI's regular accountant) to render an opinion as to the fair market value of the partnership interests in the KTVU partnership to be received by the Cox Family Members in exchange for their cash contributions. Thereafter, in 1996, CEI's management discovered that errors had been made in computing the Cox Family Members Partnership interests in KTVU Partnership. Accordingly, CEI, with the consent of the Cox Family Members, retained an investment banking firm to reevaluate the Cox Family Members' partnership interest. As a result of the investment banking firms analysis, the Cox Family Members contributed an additional $8 Million to KTVU Partnership. Notwithstanding the additional contributions by the Cox Family Members, the appraiser retained by the IRS determined that the fair market value of KTVU Partnership interests received by the Cox Family Members was $7,825,000 greater than the $62 Million which they had contributed, a difference of approximately 11%.

In reaching its decision that CEI did not recognize gain under Section 311(b), the Tax Court assumed the values determined by the IRS appraiser were correct, but nevertheless held that (i) there was a valid business purpose for the establishment of KTVU partnership; (ii) the parties did not intend to make a gratuitous transfer of value and if there was such a transfer of value it was unintentional, and (iii) the undisputed facts strongly indicate that the parties to the formation of KTVU Partnership intended an arms' length transaction. Continuing, the court rejected the proposition that the Green and Epstein cases[3] held that the mere finding of a bargain, solely based on competing property valuations, requires a finding that the transfer constitutes a constructive dividend to the shareholder, regardless of intent. 97 TCM at 1775.

Although, it is difficult to speculate as to which facts in the case were critical in causing the Tax Court to reach its decision, it appears that the Tax Court may have been influenced by the fact that the parties engaged two appraisers to ultimately determine the amount of cash that the Cox Family Members would have to contribute for their KTVU Partnership Interest. Thus, the court in reaching its decision relied on the business purpose of the transaction and the fact that "the use of outside appraisals to determine and, later, increase the family partnerships' capital contributions to KTVU Partnership . . . demonstrate that there is no reason to conclude that [any of the parties] … intended a gratuitous transfer by KTVU, Inc. to KTVU Partnership of station assets worth $60.5 Million. Rather, assuming that the transfer [in value] did, in fact occur, the undisputed facts strongly indicate that it was unintentional. Therefore, we conclude that KTVU, Inc.'s transfer of the station assets to KTVU Partnership was not intended to provide a gratuitous economic benefit to the other partners and, derivatively, to the shareholder trusts." 97 TCM at 1777.

The significance of the Tax Court decision in the Cox Enterprises case may well mean that if related parties are to structure a transaction which will be determined to be arms'-length, that each of the parties need engage their own independent counsel, financial advisors and appraisers and if there is a difference between the values so determined by their respective appraisers, the related parties, as in an unrelated party transaction, need attempt to reconcile the differences. Although taxpayers would prefer not to incur the expense of two appraisals, the benefit of having the IRS or the Courts determine that the parties did not "intend" to confer an economic benefit on the other party and intended to engage in an arms'-length transaction could result in significant tax savings and in addition the parties, in circumstances where an IRS Examining Agent is persuaded that the parties intended an arms'-length transaction, may be able to avoid the substantial additional costs and expenses which would be incurred in a contentious administrative proceeding or in litigation. ❒

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Featured Article

LLC V. "S" CORPORATION

By: Roger L. Neu, JD, Principal, The M&A Law Firm

An LLC will pay $18,790 more in taxes than an "S" corporation operating the same business with $5M in revenue and $500k in profits. The new health care law will increase that LLC deficit by an additional $4,500 starting in 2013.

LLC profit is subject to Medicare and Medicaid taxes of 2.9% (increasing to 3.8% under the new health law in 2013) on all profit allocable to <u>active</u> LLC members. In addition, the LLC is assessed a fee of $11,790 if gross revenue is equal to or greater than $5M. An "S" corporation, on the other hand, pays a 1.5% California tax on net profits, while partners of a Limited Partnership may avoid substantially all of these payroll taxes and fees on income allocable to the partners. Note, however, that starting in 2013, <u>passive</u> "S" shareholders will also be subject to the 3.8% surtax.

There are still some very good reasons to operate as an LLC, but you should carefully examine, in light of the increasing LLC taxes, if the LLC form is essential to the operations of your business. It may be time to consider an "S" corporation or Limited Partnership. Conversion out of an LLC is, generally, not a complex process.

"There are still some very good reasons to operate as an LLC, but you should carefully examine, in light of the increasing LLC taxes, if the LLC form is essential to the operations of your business."

Starting in 2013, net investment income such as interest, dividends, rents and royalties (on income of married couples over $250,000) would be subject to a 3.8% surtax, and capital gains rates are scheduled to increase from 15% to 20% next year. With the additional 3.8% "surtax," the effective <u>federal</u> rate on capital gains would go to 23.8% (plus the 10.55% California tax for a total of up to 34.35%).

Business owners should carefully review their entity structure to make sure they are not paying tax dollars that could be easily avoided. They should also carefully consider if it is beneficial to take gains this year to avoid even more draconian taxes headed our way in 2011 and beyond. ❒

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The M&A Law Firm was founded by Roger L. Neu, JD, Principal, in 1982 to provide specialized M&A legal services to privately held middle market companies ($5M to $250M). Mr. Neu was a CPA with PriceWaterhouse Coopers, graduated from Loyola Law School with honors and has advised over 250 clients in M&A transactions. The M&A Law Firm believes that privately held middle market companies should have the best representation at every step in the M&A process to achieve maximum value.

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[1]The arms'-length issue is also pertinent in the gift and estate tax area. Thus, Treas. Regulation §25.2512-8 provides that in the gift tax context "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arms' length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth." In the estate tax area, the controversy oftentimes involved the effectiveness of family negotiated buy-sell agreements to fix value. Congress sought to address this issue by enacting section 2703(b)(3) which provides that if the terms of an option, agreement, right or restriction is "comparable to similar arrangements entered into by persons in an arms' length transaction," it will be respected by the IRS if it also represents a bonafide business arrangement and is free from any donative intent.

[2]In the companion case, <u>Chambers v. Commissioner</u>, docket Nos. 16698-06 and 16699-06, the Commissioner argued that the formation of KTVU Partnership also provided a tax avoidance benefit to the life beneficiaries of the shareholder trusts which he alleged controlled CEI, since in his view the formation of KTVU Partnership effected an assignment of income by the life beneficiaries to their children without payment of gift or income taxes. The court also noted that "There appears here to be a discrepancy between the $60.5 million difference in value that [the Commissioner] would cause [CEI] to treat as resulting in recognized gain under Sec. 311(b) and the $7,825,000 difference between the determined value of the [Cox Family Members] partnership interests in KTVU family partnership and the $62 million [the Cox Family Members] contributed. We need not resolve that discrepancy." 97 TCM at 1773, fn. 10.

[3]Green v. United States, 460 F.2d 412 (5th Cir. 1972); Epstein v. Commissioner, 53 T.C. 459 (1969).

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– Mark Twain