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Jane Z. Astleford, vs. Commissioner of Internal Revenue, T.C. Memo 2008-128

The Facts:

Jane Astleford (Mrs. Astleford) is the surviving spouse of Mr. M.G. Astleford (“Mr. Astleford”) a real estate investor, who passed away in 1995. Mr. Astleford had, over the course of many years, acquired and owned either individually, jointly with Mrs. Astleford or through trusts and limited and general partnerships, various real estate investments primarily in the state of Minnesota. In 1970, Mr. Astleford and a partner, Mr. Richard T. Burger (“Mr. Burger”), each acquired a 50% interest in Pine Bend Development Co. (“Pine Bend”) and purchased approximately 3,000 acres of land near St. Paul, Minnesota. The Pine Bend general partnership agreement did not contain any provisions relating to the transfer of interests and whether such transferred interests should be treated as general partnership interests or assignee interests.

Upon Mr. Astleford’s death in April of 1995, his interests passed to Mrs. Astleford (who owned all assets either directly or indirectly through their Marital Trust). In August of 1996, Mrs. Astleford created the Astleford Family Limited Partnership (AFLP). Under the AFLP agreement, limited partners were not allowed to vote on matters relating to management of AFLP, no outside party could become a partner in AFLP without consent of Mrs. Astleford as General Partner, limited partners could not sell or transfer any part of their AFLP limited partnership interest without consent of Mrs. Astleford and no real property interest held by AFLP could be partitioned without the consent of Mrs. Astleford. On August 1, 1996, Mrs. Astleford funded AFLP with transferred property (worth approximately \$870,000) and immediately gifted a 30% limited partnership interest to each of her three children, retaining a 10% general partnership interest for herself.

In December of 1997, Mrs. Astleford transferred to AFLP her 50% interest in Pine Bend and her ownership interest in 14 additional properties located in the Minneapolis-St. Paul area. Immediately following the transfer, Mrs. Astleford again gifted additional limited partner interests to her three children in such a magnitude that the effect was to reduce her general partner interest back down to approximately 10% and increase her children’s limited partner interests to approximately 30% each.

Mrs. Astleford filed timely Federal tax returns for both 1996 and 1997. The 1996 Federal tax return claimed taxable gifts of \$277,441 with a gift tax liability of \$79,581. On her 1997 Federal tax return, Mrs. Astleford claimed a discounted value of the 1997 gifts of

\$3,954,506 with a gift tax liability of \$2,005,689. The IRS' audits determined taxable gift values of \$626,898 for 1996 and \$10,937,268 for 1997 with corresponding gift tax liabilities of \$127,619 and \$3,997,288, respectively. The IRS' determination increased the Mrs. Astleford's gift tax liability by nearly \$2,000,000.

The Arguments and Findings:

The Court was asked to determine the fair market value of a tract of land called the Rosemount Property, whether the value of a 50% interest in Pine Bend Development Company should be valued as a partnership or assignee interest, the property discounts for lack of control and lack of marketability to apply to the Pine Bend interest, and the property discounts for lack of control and lack of marketability that should apply to gifted AFLP interests.

In determining the value of the Rosemount property, Mrs. Astleford's expert utilized the market comparable approach and identified 18 farm properties which had been sold and adjusted based on date of sale, location, and size. Mrs. Astleford's expert calculated an initial value of \$3,100 per acre or \$3,681,000. He then utilized an absorption discount using a 25% discount rate over a four year period which decreased the value to \$1,817 per acre or \$2,160,000. The IRS' expert also utilized a market data approach and reviewed approximately 125 farmland properties of which he personally visited 12. The IRS' expert ultimately chose two properties he considered comparable to the Rosemount property and made adjustments based on date of sale, arriving at a value of \$3,500 per acre or \$4,156,000. The IRS' expert claimed that there should not be an additional absorption discount to his comparables. The Court agreed with the determination of a \$3,500 per acre value but determined that a four year absorption and a 10% discount rate was appropriate which resulted in the fair market value of the property to be \$2,786.14 per acre or \$3,308,575.

With the value of the Rosemount property calculated, the Court began to determine the value of the 50% Pine Bend interest. Mrs. Astleford's expert determined that the 50% Pine Bend interest should be treated as an assignee interest due to Minnesota law and trial evidence that suggested Mr. Burger had not consented to Mrs. Astleford's transfer of her Pine Bend interest to AFLP. Such interest was then discounted by 5% on the basis that under Minnesota law a holder of an assignee interest would have no influence on management and would only have an interest in the profits of Pine Bend. The IRS' expert disagreed and argued that the Pine Bend interest should be treated as a general partnership interest under a substance over form doctrine. The Court agreed with the IRS' expert and determined under a "substance over form" theory that the transfer of the 50% interest in Pine Bend should be treated as a General Partnership interest. Therefore, the discounts should be determined as though Pine Bend was a general partnership.

When determining the applicable discounts to apply to the interest in Pine Bend, Mrs. Astleford's expert utilized comparability data compiled from registered real estate limited partnerships (RELP's). The IRS' expert relied on comparability data from sales of

publicly traded real estate investment trusts (REIT's). The Court declined to declare either method superior to the other as both had been utilized in the past. The Court determined that Mrs. Astleford's expert's combined discount for lack of control and lack of marketability of 40% (chosen arbitrarily from a range of 22% to 46%) was too high. The IRS' expert concluded that because the Pine Bend interest was simply an asset of AFLP, discounts that he applied at the AFLP level obviated the need to apply any additional discounts at the Pine Bend level. The Court disagreed and determined the appropriate combined discount for lack of control and lack of marketability to be 30%.

The Court then turned to determination of the proper discounts to be applied to the 30% limited partnership interests gifted to each of the children. The Court disagreed with the methodologies used by both Mrs. Astleford's expert and the IRS' expert. After review of both experts' data, the Court determined the correct lack of control discount to be 16.17% and the lack of marketability discount of 21.23% for the 1996 gifts and lack of control discount of 17.47% and lack of marketability discount 22% for the 1997 gifts.

After calculation of all applicable discounts, the Court determined the total value of the 1996 gifts to be approximately \$517,575 and the 1997 gifts to be approximately \$6,565,215. Both calculations were higher than Mrs. Astleford's original determinations, but lower than the IRS' audit calculations.

Parting Thoughts:

Here's another case that supports the acceptance of "tiered" discounts. The Court indicated that *"the 50% interest in Pine Bend constituted less than 16% of AFLP's NAV and was only 1 of 15 real estate investments that on Dec. 1, 1997, were held by AFLP, and lack of control and lack of marketability discounts at both the Pine Bend level and the AFLP parent level are appropriate."* (FYI, in most cases the Court has generally looked to see if the lower level interest represents a significant portion of the parent entity's assets in making this determination). While additional tax was owed by Mrs. Astleford, the discounts allowed by the Court were still quite sizeable (especially after factoring in the 30% combined lack of control and lack of marketability discount of the Pine Bend interest).