John G. Mack, ASA, CBA
Mack Business Appraisals, LLC
26956 N. 90th Lane
Peoria, Arizona 85383
(888) 789-2401 (toll free) (623) 340-6770 (direct) (623) 476-5405 (fax)
john@mackbusinessappraisals.com
www.mackbusinessappraisals.com

Estate of Samuel P. Black, Jr. vs. Commissioner, 133 T.C, No. 15, December 14, 2009.

<u>The Facts:</u>

Mr. Samuel Black ("Mr. Black") was employed by Erie Indemnity Company ("Erie") in various ways (employee, officer and director) from 1927 until he retired from the board of directors in 1997 (at the age of 95). Mr. Black was a major contributor to Erie's success and had accumulated stock in Erie steadily throughout his entire lifetime.

In 1988, Mr. Black gave gifts of Erie stock to his son ("Samuel III") and two grandsons. Mr. Black became concerned, for various reasons, the stock would be sold by both his son and grandsons. Accordingly, in March of 1993, Mr. Black, his son and grandsons, after consulting with financial advisors, contributed their Erie stock to Black LP in exchange for partnership interests proportionate to the fair market value of the stock contributed. At the date of contribution in 1993, Mr. Black owned approximately $68 million of Erie stock and Samuel III and his two sons owned approximately $12 million of Erie stock. Black LP managed the Erie stock holdings from 1993 to 2001, and oversaw its growth from $80 million to over $315 million.

In 1998, Mr. Black had transferred his 1% General Partnership interest to his son, and upon his death, at the age of 99 in 2001, Mr. Black owned an approximate 77% limited partner equity interest in Black LP. Mr. Black's estate plan established a marital trust for Mrs. Black and had a $20 million bequest to a university endowment. Mr. Black passed away in December of 2001, and Mrs. Black died approximately five months later (but before there was time to fund the marital trust – which was intended to be funded with a significant portion of Mr. Black's interest in Black LP).

Mr. Black's estate paid the estate tax owed on Mr. Black's estate, but considered the marital trust to be funded as of the date of death of Mrs. Black. Thus, Mrs. Black's estate tax and other liabilities owed was significant and her estate lacked sufficient liquid assets to discharge the tax and other liabilities. In order to help with the liquidity problem, Samuel III (the general partner) agreed to have BLP sell some of its stock in Erie in a secondary offering. This sale raised $98 million, of which $71 million was lent to Mrs. Black's estate by BLP. The interest expense on the loan was payable in a lump sum on the purported due date (more than 4 years from the date of the loan), and was deducted in full on Mrs. Black's estate tax return. Mrs. Black's estate used the funds to discharge its Federal and State tax liabilities, pay the $20 million bequest to the university endowment, reimburse Erie's costs of approximately $981,000 in connection with the secondary offering and pay $1,155,000 each to Samuel III (as executor fees) and to a law firm (as legal fees associated with the Estate).

The IRS argued that: (1) the value of the Erie stock apportionable to Mr. Black's partnership interest in Black LP at his death is includable in his gross estate under Section 2035(a) or 2036(a)(1); (2) the marital deduction to which Mr. Black's estate is entitled is limited to the value of the partnership interest in Black LP that actually passed to the marital trust; (3) the deemed funding date of the marital trust and the size of the Black LP interest includable in Mrs. Black's estate should be determined by reference to the value of Black LP on the date of Mr. Black's death and not Mrs. Black's death when the value was higher and it would require a smaller interest in Black LP to fund the trust; (4) the interest payable on the Black LP loan to Mrs. Black's estate is not a deductible administration expense; and (5) Mrs. Black's estate is not entitled to deduct the $981,000 of Erie's secondary offering costs and is only entitled to deduct $500,000 of the son's executor fees and $500,000 of the legal fees. Thus, the IRS assessed deficiencies on both estates of over $200 million.

<u>The Arguments and Findings:</u>

The Court was asked to determine if there was a bona fide sale of Erie stock upon the funding of Black LP in 1993. The Court determined that there was in deed a bona fide sale of stock for full and adequate consideration to Black LP and that its seven year existence and operating history was enough to provide a "legitimate and significant non-tax purpose" for the partnership's existence. In addition, the Court noted that Mr. and Mrs. Black had retained approximately $4 million of assets, outside the trust with an average income of $600,000 per year and therefore did not utilize any trust principal for their daily living expenses.

In regard to the marital trust, it was deemed to have been funded from the estate of Mr. Black. Because the funding of the marital trust would have occurred in due course after the death of Mr. Black, the valuation of the trust was determined as of the date of death of Mrs. Black. The loan of $71 million from Black LP to the estate was determined to be completely within the control of Samuel III, as executor of the estate, and owner of the controlling interest in Black LP. The loan was deemed not "necessarily incurred" within the meaning of Section 20.2053-3(a) and therefore, the interest expense was deemed not a deductible administration expense.

Furthermore, the Court determined that Mrs. Black's estate was entitled to deduct: (1) $481,000 of the $981,000 of secondary offering costs reimbursed to Erie, (2) half of the son's executor fees and (3) half of the legal fees (as the Court determined that ½ of those amounts represented expenditures or effort on behalf of Mrs. Black's estate as opposed to both Mr. and Mrs. Black's estates).

Parting Thoughts:

This case provided a rather detailed look into what represents a "bona fide sale" and what is deemed to be "full and adequate consideration". I found it interesting in that there was no discussion as to valuation discounts (e.g. minority interest discount and lack of marketability discount) that were applied in determining the fair market value of the limited partner equity interest in Black LP.