Mack Business Appraisals, LLC

Valuation Insights

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Tips to Keep Your FLP from Flopping

Family Limited Partnerships ("FLP's") have become a very popular tool to use in an estate plan. Not only can they help significantly reduce estate taxes, but they also can provide many other benefits including, but not limited to, liability protection and asset management. With most FLP's, a parent transfers assets to an FLP in return for both a General Partner ("GP") and Limited Partner ("LP") interest in the FLP (often a 1% GP and 99% LP interest). After formation, the parent gifts LP interests in the FLP to one or more heirs. The tax saving benefits are derived from the fact that the value of the LP equity interests gifted are reduced to reflect the fact that such interests represent a minority interest with no control over the FLP's operations and that these interests suffer from lack of marketability (being a privately-held entity). Thus, the parent can achieve a much bigger "bang for their buck" in the gifting process as more asset value can be transferred when transferring LP equity interests. Such discounts can often range from approximately 30% to nearly 50% depending on the facts and circumstances surrounding each specific case. As most of you know, over the past several years the IRS has attacked the use of FLP's and had some well publicized victories. Two recent IRS victories occurred in the cases of Rector v. Commissioner (TC Memo 2007-367) and Erickson v. Commissioner (TC Memo 2007-107) (for a full write-up of these cases please go to the court case summaries page of our website which is located at www.mackbusinessappraisals.com). However, most of the IRS' victories in recent years have been victories because of cases of bad facts and/or improper use of the FLP.

How do you keep your FLP from flopping? Here are some tips that I have compiled based upon my review of prior FLP cases over the last several years that will help protect the FLP from a successful IRS challenge.

1. It is important for the client to utilize competent legal counsel with specialized knowledge in the area of using FLP's as a part of an estate plan.
2. Make sure that your FLP's Limited Partnership Agreement does not contain any provisions which would nullify the ability of the business appraiser to take discounts (we always prefer to review the Agreement for a new client before the gift is made to alert the attorney to any potential problems we see in providing the appraisal).
3. Be sure to document valid nontax business purposes in the LP Agreement.
4. Follow the formalities and treat the FLP like a business. Hold annual meetings, discuss investment performance and other business matters and disclose financial information yearly to all partners in a timely manner.
5. Don't Co-Mingle! This is a really big one and is related to treating the FLP like a business. Establish separate bank accounts and don't let the Partners use it as their personal pocketbook.
6. Timely fund the FLP upon formation (see Erickson V. Commissioner TC Memo 2007-107 for what can happen if you don't timely fund the FLP).
7. Don't transfer all of the individuals' assets into the FLP. Make sure the individual retains enough personal assets to live on, without using FLP assets or income to pay for basic needs.
8. For FLP's that hold marketable securities, it is better to own a diversified portfolio and have this portfolio actively managed and monitored as opposed to only owning a few securities with minimal activity (this helps substantiate the business purposes).

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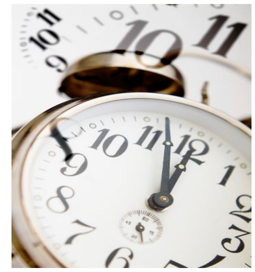
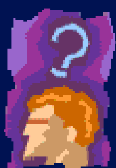
SBA New SOP's to Increase Need for Independent Business Valuations





Did you know:

According to Grant Thornton International Business Report, 48% of private businesses in the United States are planning to grow through acquisition within the next three years?

The Small Business Administration (SBA) is implementing new Standard Operating Procedures (SOP's) effective August 1, 2008. The new SOP 50-10(5) was completely re-written to develop a more concise version of the SOP that is up-to-date and user friendly (although it's still a few hundred pages long). The biggest change that will impact the business valuation field is that the SBA will now require an independent valuation of the business from a qualified source for all loans greater than $350,000 (or if there is a close relationship between the buyer and seller). This is a drastic reduction from the previous threshold that required an independent valuation of $1,000,000. The SBA has now also defined the term "qualified source" as used above to mean an individual who regularly receives compensation for business valuations and is accredited by a recognized organization such as:

1. Accredited Senior Appraiser (ASA) accredited through the American Society of Appraisers.
2. Certified Business Appraiser (CBA) accredited through the Institute of Business Appraisers.
3. Accredited in Business Valuation (ABV) accredited through the American Institute of Certified Public Accountants.
4. Certified Valuation Analyst (CVA) as offered through the National Association of Certified Valuation Analysts.

We look forward to helping our area bankers meet these new valuation requirements.

Thomas H. Holman, Jr. and Kim D.L. Holman, Petitioners vs. Commissione of Internal Revenue, Respondent T.C. Memo 130-12, May 27, 2008

<u>The Facts:</u> Mr. and Mrs. Holman are the parents of four children. Mr. Holman was employed by Dell and ha acquired a large block of Dell stock which the couple wanted to preserve for their daughters sake. On Novembe 3, 1999, Mr. and Mrs. Thomas Holman formed the Holman Family Limited Partnership (the "Partnership"). Th purpose of the Partnership was to accomplish four goals: (1) long-term growth, (2) asset preservation, (3) ass protection, and (4) education. The Partnership was initially funded with 100 shares of Dell Corp. stoc owned by a trust established for the children and 70,000 shares of Dell Corp. stock contributed jointly b Mr. and Mrs. Holman. Gifts of limited partnership interests were made to each child five days after the Par nership's formation on November 8, 1999, and again on January 4, 2000 and February 2, 2001. By 2001, du to additional transfers of Dell Corp. stock, the Partnership owned 111,100 shares of Dell stock.

The Partnership Agreement included standard prohibitions against transfer typically seen in family limite partnerships. However, the Partnership Agreement included a buy-out clause for any prohibited transfe that allowed the Partnership to repurchase the transferred shares at "its fair market value based upon th assignee's right to share in distributions from the Partnership as determined by an appraisal performed by a independent appraiser." In addition, the Partnership had the option to pay that price at "ten percent of th purchase price at closing and pay the balance of the purchase price in five equal annual installments together wi interest at the Applicable Federal Rate."

Thomas H. Holman, Jr. and Kim D.L. Holman, Petitioners vs. Commissioner of Internal Revenue, Respondent T.C. Memo 130-12, May 27, 2008—Continued

The Holman's filed IRS Form 709 Gift Tax Returns and claimed a total combined discount (for both lack of marketability and minority interest) that varied from 41.5% to 45.6% over the years of gifting.

The Arguments: The IRS made four separate arguments against the Holman's and contested the valuation discounts. The IRS' arguments were (1) the gift of FLP interests was actually an indirect gift of Dell stock to their daughters, (2) Section 2703 rendered the Partnership's transfer restrictions invalid, (3) the Partnership was not a valid operating business, and (4) the valuation discounts taken were excessive.

The Findings: First, the Court determined that there was no indirect gift. The Partnership was formed and five days passed prior to the initial gifting of FLP units providing time for "real economic risk of a change in the value." The Court stated "We shall not disregard the passage of time and treat the formation and funding of the Partnership and the subsequent gifts as occurring simultaneously under the step transaction doctrine."

In regards to the second and third arguments, the Court ruled that Partnership transfer restrictions were not to be considered for valuation purposes because, in regard to Sec. 2703(a) restrictions, the Court concluded, "we find the restrictions do not constitute a bona fide business arrangement within the meaning of Section 2703(b)(1)." Furthermore, the transfer restrictions were determined by the Court to be "a device to transfer LP units to the natural objects of petitioners' bounty for less than adequate consideration."

Lastly, regarding excessive valuation discounts, Mr. Holman's expert argued for minority interest discounts that varied from 10.0% to 16.3% over the course of the gifting while the IRS expert's minority interest discounts ranged from 5.0% to 13.4% over the course of the gifting (with most years being relatively close). However, the area of major disagreement was that the IRS expert recommended reducing the taxpayers claimed 35% marketability discount to 12.5% based on a convoluted analysis of restricted stock studies. Both experts arguments were considered, however, the Court chose to disregard Mr. Holman's expert due to lack of supportability of his arguments and agreed with the IRS expert's determinations due to his "more thoughtful" approach.

Parting Thoughts: I totally disagreed with the Court's determination and reliance on the IRS's expert for the lack of marketability discount. This is a case where the poor outcome in terms of a lack of marketability discount for the taxpayer resulted simply because the IRS' expert did a better job of supporting his valuation conclusions (however convoluted and unreasonable that support may be).

Cubs Corner: The Cubs have a 57-38 record at the All-Star Break—which is tied for the best record in baseball with the Los Angeles Angels. This is the first time EVER that the Cubs have had the best record in baseball at the All Star Break. They also have a 37-12 record at home—which is their best home record since they started playing at Wrigley Field in 1916. Also, did you know that Wrigley Field was originally called Weeghman Park from 1916-1920 and Cubs Park from 1920 to 1926 before being renamed to Wrigley Field? It originally cost only $250,000 to build and had a seating capacity of 14,000.

Visit our website located at
www.mackbusinessappraisals.com

Mack Business Appraisals, LLC

26956 N 90th Lane
Peoria Arizona 85383
Phone 623-340-6770
Fax 623-476-5405
E-mail john@mackbusinessappraisals.com

About Mack Business Appraisals, LLC

Mack Business Appraisals, LLC is an experienced valuation firm that provides expert business valuation services to businesses across the United States for various purposes including, but not limited to: gift and/or estate tax, merger and acquisition, ESOP's, FASB 141/142, buy-sell agreements, S-corporation election, SBA funding, stock option granting and management planning purposes. Mack Business Appraisals, LLC also has extensive experience in valuing family limited partnerships (FLP's) and limited liability companies (LLC's) for gift and estate tax purposes.

John G. Mack, ASA, CBA, is the managing member of Mack Business Appraisals, LLC. Mr. Mack is a 1993 graduate of the University of Iowa with a Bachelor's degree in Finance from the College of Business Administration. Mr. Mack is an accredited member of the American Society of Appraisers (ASA), Business Valuation Discipline, and has also attained the Certified Business Appraiser (CBA) designation as offered by the Institute of Business Appraisers. Inc.