

Valuation Insights

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Did you know:
ESOP plans nation-
wide held nearly
\$928 billion dollars
worth of assets as of
early 2008?

Successful ESOP Implementation Largely Dependent on Expert Planning & Guidance

There are over 11,500 Employee Stock Ownership Plans (ESOPs) established in the United States that cover over 10 million employees (or 10% of the private sector workforce). An ESOP can be a great tool for many companies, but ESOPs do not make sense for all companies. Over the years I have noticed that many business owners who are considering implementing an ESOP do not obtain adequate expert guidance in terms of structuring the ESOP or valuation guidance when assessing the initial feasibility of the ESOP. As with most planning scenarios, garbage in = garbage out. Thus, business owners that do not work with firms that specialize in properly setting up and structuring ESOPs and do not have an independent valuation of their business performed to determine the initial feasibility are often greatly disappointed in the end result and set both the ESOP and Company up for failure. Do you have a client that is contemplating their exit plan and wants to know more about ESOPs? Give us a call and we will not only help you with your preliminary valuation assessment for ESOP feasibility, but we can also introduce your client to experts that specialize in ESOP structuring and implementation (if needed) so that they can determine if an ESOP is right for them.

Bianca Gross, Donor, Petitioner vs. Commissioner of Internal Revenue Service, Respondent, TC Memo 2008-221, September 29, 2008

The Facts: Ms. Gross, a widow, was predeceased by her husband in 1996. Ms. Gross was an avid investor who purchased and sold securities. By 1998, Ms. Gross had acquired a sizeable portfolio of publicly traded securities. Due to her husband's death and considering her own mortality, Ms. Gross had begun considering ways to preserve her portfolio for her two grown daughters. Ms. Gross settled on a family limited partnership as she believed this to be the best option to encourage her daughters to work together and learn from her experience while she maintained control of the partnership's assets as the sole general partner. After several meetings and discussions with her daughters, on July 15, 1998, Ms. Gross and her daughters agreed to form a FLP. In addition to the agreement, the basic terms of the partnership were agreed upon and were as follows:

- Each would contribute a small amount of cash to the Partnership (\$100 from Ms. Gross and \$10.00 each from her daughters);
- Ms. Gross would retain ultimate control over the management of the partnership as the sole general partner and majority owner, including the authority to make decisions regarding sales, purchases and other dispositions of partnership assets;



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To Avoid the Indirect Gift Rule, Taxpayers must prove :

1. The contributing partner received partnership interests in exchange for their contribution;
2. The contributing partner's capital account was credited for the transfers at FMV; and
3. Crediting of the capital account occurred prior to the gifting of any partnership interests.



Bianca Gross, Donor, Petitioner vs. Commissioner of Internal Revenue Service, Respondent,

TC Memo 2008-221, September 29, 2008, Continued

- Ms. Gross would retain exclusive discretion concerning timing and amounts of distributions;
- The daughters would not be able to transfer their interests without the consent of Ms. Gross;
- The daughters could not withdraw from the partnership and were not entitled to a return of their original capital contribution;
- The daughters could not force a partnership dissolution;
- Each partner's interest in the partnership would be based on the amount of her contribution of capital.

On July 15, 1998, Ms. Gross filed a certificate of limited partnership for "Dimar Holdings, L.P." with the state of New York Department of State. Ms. Gross also caused notice of formation to appear in New York newspapers and on October 14, 1998, caused an affidavit of publication to be filed with the New York Department of State.

Ms. Gross' daughters each contributed checks in the amount of \$10.00 to the partnership on July 31, 1998, and Ms. Gross contributed a check for \$100.00 on November 16, 1998. Beginning in October of 1998 and continuing through December 4, 1998, Ms. Gross transferred ownership of stock shares from her name to the partnership, and recorded each transaction in a notebook titled "Dimar". On December 15, 1998, the fair market value of the portfolio was \$2,158,646 and the value of all Dimar assets was \$2,158,766. (with the \$120 difference being the original capital contributions of Ms. Gross and her daughters). Ms. Gross filed a tax return for the partnership for 1998, showing it had begun operating as of July 15, 1998.

On or before December 15, 1998, Ms. Gross and her daughters executed a document styled "Limited Partnership Agreement of Dimar Holdings L.P." which cemented the original agreement reached in July of 1998. Also, at this meeting, Ms. Gross and her daughters executed "Deed of Gift" documents indicating that Ms. Gross was transferring a 22.25-percent limited partnership interest to each daughter. Ms. Gross filed the appropriate gift tax return for the transfer of the limited partnership interests which indicated that the value of the 22.25% limited partnership interests gifted was \$312,500 (and was derived using a total valuation discount for lack of control and lack of marketability of approximately 35%).

The Arguments: The IRS argued that the limited partnership interests transferred to Ms. Gross' daughters were actually indirect gifts of securities and that the correct value of each indirect gift was \$480,299. In defense of their argument, the IRS expert claimed that the formation of Dimar did not occur until December 15, 1998, the same day the transfers were made, because the limited partnership agreement was not finalized until that date. In addition, the IRS expert argued that while securities were

placed into the partnership beginning in October of 1998, since no partnership was established, they could not have been contributed to an entity that did not exist. In support of its argument, the IRS relied on a schedule attached to the Form 709 which included a list of Dimar securities under the heading “Securities Contributed to the Partnership on 12/15/98”.

Ms. Gross argued that according to New York law, the partnership had been formed the date of the filing of the certificate of limited partnership, July 15, 1998. Ms. Gross further contended that even if Dimar was not qualified as a limited partnership until December 15, 1998, it would have been a general partnership under New York law as of July 15, 1998. Ms. Gross also argued that all securities had been transferred to the partnership no later than December 4, 1998, and the schedule attached to the Form 709 was only for illustrative purposes of the partnerships holdings.

The Findings: After consideration of New York law and both parties’ arguments, the Court concluded that Dimar had in fact been established on July 15, 1998. In addition, the Court concluded that the evidence was convincing that Ms. Gross had transferred securities into Dimar from October through December 4, 1998, and that all transfers had been completed prior to the transfer of limited partnership interests to her daughters on December 15, 1998.

In response to the argument that the transfer of limited partnership interests was actually an indirect gift of securities, the Court reviewed the Estate of Jones v. Commissioner and Shepard v. Commissioner. The Court also reviewed indirect gifts under the step transaction method and reviewed Holman v. Commissioner. The Court determined that because Ms. Gross made a series of contributions to Dimar and received increasing partnership interests in return, all of which were reflected in her capital account, while not enhancing the capital accounts of her daughters, Ms. Gross made gifts of partnership interests to her daughters and not indirect gifts of securities. In regard to the step transaction, the Court concluded that the step transaction would not cause the Court to change the order of the transaction because 11 days had passed between the transfer conclusions and the interests being gifted and the Dimar securities were mostly, if not all, common shares of well known companies.

Parting Thoughts: In this case, the IRS stipulated to a combined minority and lack of marketability discount of 35% **IF** it was determined that the gifts were not an indirect gift. I guess they thought that their odds were pretty good on this one but upon closer analysis, I believe that the facts clearly supported the taxpayer and ultimately this was a good decision by the Tax Court. Another victory in the support of FLPs that own marketable securities with a total valuation discount again being approximately 35%.



Cubs Corner: While the Cubs finished with the best record in the National League (97-64) and had their second straight postseason appearance for the first time in 100 years, they fell far short of expectations in the playoffs as they were swept by the Los Angeles Dodgers in the NL Divisional Series. It will be an interesting offseason to see how they attempt to shore up their weaknesses to make next year’s team even better. It took me about 10 days to break out of my depression after their early playoff exit but I’m already starting to look forward to next year!



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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 (FLPs) and limited liability companies (LLCs) for gift and estate tax purposes.

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