MARSHALL & STEVENS

GIFT & ESTATE TAX WIN

THE CASE THAT SET PRECEDENT FOR FLP VALUATIONS

CASE STUDY

Taxpayer Victory in the First FLP Tax Court Case

Church v. United States, No. SA-97-CA-077400G

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Challenge

The first Family Limited Partnership (FLP) case to be challenged in court by the IRS was the Estate of Elsie J. Church ("The Estate").

The Estate held a 62% limited partnership interest in an FLP which owned marketable securities and an undivided interest in rural real estate. The Estate's IRS Form 706 tax return was filed with a 35% discount from Net Asset Value ("NAV"), but with no supporting business appraisal. The IRS proposed that no discount from NAV was applicable.

Bruce A. Johnson, ASA, Executive Managing Director for Marshall & Stevens (M&S – formerly Munroe, Park & Johnson) was retained to serve as valuation expert for the taxpayer to appraise and testify in tax court.

Approach

In his USPAP-compliant report, Mr. Johnson explained that a noncontrolling interest should be valued based on the income generating ability of the entity and not the liquidation value. Utilizing the Income Approach, cash flow available for distribution from the FLP was discounted to present value using a rate of return that reflected the risk of the partnership from an investment perspective. A value indication was also determined based upon a Market Approach, using closed-end funds and real estate limited partnerships from Partnership Profiles. The Income and Market approach value indications were reconciled to determine an opinion of the marketable, noncontrolling value for the FLP. A discount for lack of marketability ("DLOM") was then deducted using the Johnson/Park Empirical Method to increase the rate of return of the limited partnership interest to offset the risk of the lack of marketability.

Outcome/Solution

The court found that Mr. Johnson's methodology was sound and supported by authoritative publications. The combined discount for lack of control ("DLOC") and DLOM of 57.6% in the Johnson report was upheld by the tax court. The court rejected the IRS's attempts to invalidate the partnership agreement using IRC 2703[1].

This case set the precedent for the valuation of FLPs using the Income and Market Approaches as best practice methodologies.

1: § 2703. Certain rights and restrictions disregarded

(a) General rule: For purposes of this subtitle, the value of any property shall be determined without regard to— (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property.

(b) Exceptions: Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements: (1) It is a bona fide business arrangement. (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth. (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

(Added Pub. L. 101–508, title XI, §11602(a), Nov. 5, 1990, 104 Stat. 1388–498.)