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VALUATION REPORT

COURT CASE UPDATE
FLP Stands up to Scrutiny in Long-Running Court Battle

Talk about high courtroom drama! There's no legal series on television, no John Grisham novel, no fictional law school case study that could compare to the twists and turns of *Keller v. U.S.*, a Texas court case involving the valuation of a family limited partnership (FLP).

After 12 years, this case has finally been resolved in the Fifth Circuit Court of Appeals — and the taxpayer prevailed.

In the Beginning
The case started in a relatively straightforward manner. Maude Williams, an elderly woman who died in 2000, left an estate worth more than $400 million. Her financial advisors, including CPA Rayford Keller, after whom the case is named, had initiated an estate plan that included an FLP. Mrs. Williams had signed the FLP documents shortly before she unexpectedly passed away, but the FLP had not yet been funded. Believing that this lack of funding precluded transfer of her assets to the intended FLP after her death, her estate tax return was filed as required, and her estate paid more than $147 million in federal taxes in 2001.

Later that year, Rayford Keller's son Lane, also a CPA, attended a continuing education seminar and discovered that, according to precedent set in *Church v. U.S.*, Mrs. Williams' FLP was indeed considered to be established. Keller executed Mrs. Williams' original plan to fund the FLP. In November 2001, the estate filed an IRS Claim of Refund for $40 million.

Enter the Valuation Experts
The IRS balked and the case was on its way to court. But before the trial even started, the estate's attorneys attempted to exclude key portions — if not all — of the valuation report prepared by the IRS valuation expert, Alan Shapiro. Shapiro was a highly credentialed economist, but he had no recognized valuation credentials and was inexperienced in federal estate tax valuation.

The estate argued that Shapiro's report was irrelevant and inadmissible because he violated the tenets of the fair market value standard in three significant ways:

1. Shapiro considered the "actions and motivations of specific people." According to federal estate tax laws, the true identities of the buyer and seller are not to be considered. Buyers and sellers must be hypothetical.

2. Shapiro speculated on events occurring after the valuation date, including possible cooperation between minority interest owners. For fair market value determination, such speculation isn't allowed.

3. Shapiro's calculations aggregated the interests of different owners, which is not permissible. Fractional interests must be valued as separate interests.

Moreover, apparently unaware that he was violating the fair market valuation standard, Shapiro confirmed all of his flawed assumptions in a 2003 deposition.

About Those Discount Calculations
The estate further argued that Shapiro's calculations for a lack of control discount were incorrect because they were based on one insubstantial and insignificant factor — a lack of voting rights. The estate argued that Shapiro overlooked many important elements that contribute to lack of control and "simply opted for the one element that yielded the lowest discount."

The estate also disagreed with Shapiro's methodology for calculating the lack of marketability discount. Shapiro relied on two stock studies, neither of which the estate nor the court found to be compelling. Rather, the estate argued, the court

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should look to its expert's report, which concluded that a 35 percent lack of marketability discount, a 15 percent lack of control discount and a 5 percent assignee interest discount were appropriate.

The Court Speaks

Finally, after years of delays and one failed attempt at mediation, *Keller v. U.S.* went to trial in 2007. The District Court's ruling, issued two and a half years after the four-day trial, covered several important and interesting aspects of the case:

- FLP intent prevailed. Even though Mrs. Williams' FLP wasn't funded before she died, it was clear to the court that she had approved her advisors' very specific plans to do so.
- The FLP was legitimate. Despite IRS claims to the contrary, the court found that Mrs. Williams' FLP had a legitimate business purpose other than "recycling of wealth" and reduction of federal tax liabilities.
- Shapiro's valuation was nixed. The court agreed that Shapiro had violated the three valuation tenets and rejected his conclusions altogether. Instead, the court accepted the estate's valuation expert's opinion regarding discounts, and agreed to a 47.5 percent discount — a relatively high number compared to most other successful FLP court cases.
- Original tax payment considered a loan. The court concluded that the FLP was due interest on the original estate tax payment of $147 million, which the estate "borrowed" from the FLP to pay the tax. The interest amount — nearly $5.8 million per year — was deemed deductible from the estate as an administrative expense.

The bottom line? The estate reduced its tax liability by more than $40 million. In September 2012, the U.S. Court of Appeals for the Fifth Circuit upheld the District Court's original ruling and, perhaps now, the case is finally closed.

Key Takeaways from the Case

For attorneys, financial advisors and individuals interested in estate planning, this case underscores the fact that FLPs still work as estate planning tools as long as those setting up the FLP follow the rules. It also underscores the importance of keeping thorough, accurate records like the Kellers did. You never know when you may need them to prove intent in court.

Finally, this case highlights the importance of choosing the right valuation analyst as an expert witness. The government's case was severely hampered by Shapiro's lack of valuation experience and egregious errors, and the taxpayer prevailed.

For more information about this or other valuation-related cases, please contact us at 314.862.2070.

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Tax-Affecting: Judge Says the "Door Is Open" for the Right Case

Another valuation court case is also attracting attention. Although it's more than a decade old, Gross v. Commissioner is still one of the most influential U.S. Tax Court rulings. The case, in which the court rejected the idea of tax-affecting the earnings of S corporations, has since been affirmed by several subsequent cases. Valuation analysts generally consider these rulings to be wrong.

It turns out that some tax court judges may agree with the valuation community. When directly asked about the issue at a recent tax summit, Senior Judge David Laro said, "Is the Tax Court saying as an institution that it will [never] tax-affect an S corporation? I think it bears further review." He then stated that "the door is open" for the full court to review the matter and issue a Tax Court Opinion if the right case came along.

The valuation community has been encouraged by Laro's words. It appears that there's hope for the future of tax-affecting.

COMPENSATION MATTERS

Salaries vs. Dividends: What's Reasonable?

Business owners and their accountants spend a fair amount of time considering compensation — because "reasonable" compensation is a big issue in terms of taxes and business value. For S corporation owners, the more money they take in salary (rather than as dividends), the higher their tax liability. Since the IRS is interested in maximizing tax revenue, the agency has a vested interest in making sure owners take a reasonable salary that's not too high based on their actual duties and in comparison with their peers.

Owner compensation also varies according to circumstances and the owner's potential interest in manipulating business value. For example, if the owner is getting divorced, he or she might take more in compensation in order to lower the value of the business — thereby lowering the value of the asset to be divided between spouses. Conversely, if the owner is selling the business, he or she might take less in compensation so the company's cash flow looks better.

Normalizing Compensation

Reasonable compensation is of interest to valuation analysts because their job involves "normalizing" the owner's compensation to reflect the salary and benefits a non-owner would be paid to do the same job.

Determining reasonable compensation is not as straightforward as it might seem. The difficulty (and resulting litigation) often stems from the many factors that influence what's "reasonable" and the assumptions made by valuation analysts as they attempt to normalize compensation. Analysts typically use several tactics to determine what's reasonable:

1. Job description – What is the owner actually doing in his or her job? The analyst looks at job duties, education, experience, knowledge, skills, responsibilities and the time and effort the owner puts into running the business. The analyst also considers standard industry practices, the company's performance, historical compensation practices, the competence of others on the management team, and the owner's benefits. Looking at all of these factors together usually gives the analyst a general idea of the reasonableness of the owner's compensation.

2. Compensation databases – Valuation analysts also dig into various compensation databases to determine reasonable comp. There are many databases to choose from, depending on the target company's industry, size and other characteristics. For example, the U.S. Department of Labor maintains a free online database, "America's Career Infonet" (http://www.acinet.org) that's searchable by occupation and location. Aon Consulting's "Executive Compensation Database" covers publicly traded companies, while Aspen Publishers' "Officer Compensation Report" focuses on compensation for small to midsize businesses in eight different industry groups. The Economic Research Institute's "Salary Assessor" covers 2,000 industries, multiple cities and nearly 5,000 positions.

3. Human resources analysis – Even more data points are available via customized human resources studies. Conducted by independent compensation experts, these studies provide valuation analysts with highly targeted research related to the company's specific profile and unique circumstances.

Credibility Counts

The point of this data gathering is to determine a reasonable compensation number that will withstand scrutiny by the IRS or an opposing attorney or expert witness in a court case. The valuation analyst's numbers must be based on reliable data, calculated in a reasonable way, and documented thoroughly

Because this is one of the most litigated areas of taxation, it's important to work with analysts experienced in determining reasonable compensation. They must be able to clearly explain calculations and assumptions, and defend their conclusions in court.

Our experienced valuation professionals are ready to assist you. Contact us today at 314.862.2070 to discuss your reasonable compensation questions.

Why Valuation Credentials Count

When hiring a valuation analyst, it's important to look for an experienced professional. Many analysts pursue credentials from one of several well-known organizations, including the American Society of Certified Public Accountants (AICPA), the American Society of Appraisers (ASA) and the National Association of Certified Valuation Analysts (NACVA), which merged with the Institute of Business Appraisers (IBA) last summer.

ABV: Accredited in Business Valuation – This AICPA credential requires a CPA license and AICPA membership, completion of the ABV examination, and a minimum of either six valuation engagements or 150 hours of valuation experience. ABV candidates must also complete 75 hours of valuation-related continuing education.

ASA: Accredited Senior Appraiser – This designation from the American Society of Appraisers requires a four-year degree, the equivalent of five years of full-time appraisal experience, a series of business valuation courses and exams, submission of an appraisal report that meets the examining committee's approval, and ongoing CPE. ASAs follow the Uniform Standards of Professional Appraisal Practice (USPAP), developed by the Appraisal Foundation, which was authorized by Congress as the source of appraisal standards and appraiser qualifications.

CVA/AVA: Certified/Accredited Valuation Analyst – These credentials require NACVA membership, two years of related experience or at least 10 completed valuations, six references and successful completion of a five-hour exam. The CVA requires a CPA license but not an MBA degree. The AVA requires a business degree or MBA, but not a CPA license.

CBA: Certified Business Appraiser – The CBA is now administered through a NACVA division known as Appraisal Database and Mentoring Services (ADAM). The CBA requires ADAM membership, a four-year degree plus ADAM's valuation training, an exam and two demonstration reports.

Mueller Prost PC offers practical solutions and insightful advice to individuals, businesses and non-profit organizations, providing a full range of audit, tax, accounting and business advisory services. The experience of our more than 80 accountants, engineers, operations leaders and former business owners gives us a unique and comprehensive perspective to address the needs of growing organizations. In addition, we leverage our membership in PKF North America (an association of more than 100 legally independent accounting and consulting firms) to enhance our national and international capabilities. For more information, visit **www.muellerprost.com**.

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