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Two Taxpayer Victories Demonstrate Winning Facts for FLPs

As textbook examples of how to form, fund, and operate a family limited partnership (FLP)—sufficient to value various assets (including publicly traded securities, real estate, and restricted holdings) at substantial discounts for federal estate tax purposes—the *Murphy* and *Black* cases make excellent reading for attorneys and financial advisors alike.

Legitimate business purpose proves critical. The Murphy Oil Corp. grew from a small family-owned business into a $2 billion international conglomerate. During the 1990s, Mr. Murphy established an FLP with $89 million in company stock plus bank and real estate holdings. Importantly, this represented only half his net worth and he never mingled his personal assets with the FLP's. Overall, the father retained a 95% limited partnership interest in the FLP, with his two sons in charge of daily operations.

For five years, the FLP traded assets, managed employees, held regular meetings, and prepared regular statements. It made only two distributions, with appropriate adjustments to the partners' capital accounts. After the father died unexpectedly in 2002, the IRS cited over $34 million in tax deficiencies and the estate sued for a refund. In *Murphy v. U.S.*, **2009 WL 3366099 (W.D. Ark.)(Oct. 2, 2009),** the federal court found the FLP was created to:

- Pool and invest the family assets according to the father's philosophy;
- Pass management responsibility onto the next generation;
- Enable the father to gift interests in the FLP while the underlying assets stayed under central management;
- Educate the father's heirs about wealth acquisition, management, and preservation; and
- Protect the family assets from creditors, divorce, and dissipation by future generations.

Moreover, the FLP was an active, ongoing entity that respected partnership formalities. Based on these strong facts, the court concluded the FLP was established for legitimate and significant non-tax purposes, sufficient to exclude the value of its underlying assets from the father's gross estate per IRC Sec. 2036(a)(1)(bona fide sale exception for adequate consideration).

To value Mr. Murphy's 95% LP interest, the court considered the parties' credentialed experts, who took the net asset values of the underlying interests before applying Rule 144 and blockage discounts as well as minority and marketability discounts. Their results diverged widely, but in each instance the court found the taxpayer's expert to be more credible, largely because he considered specific qualitative factors, including the FLP's substantial cash balance and the relative holding period, risk, distribution policy, and transfer restrictions of its assets. After adopting all the estate's discounts, the court found the fair market value of the 95% Murphy LP interest to be $74.5 million—and ordered a complete tax refund.

Another winning story. Samuel Black worked his way up from peddling newspapers on the street to senior vice president and second largest shareholder of the Erie Indemnity Co., a national insurance company. To pool, protect, and prolong his family's wealth, Mr. Black formed an FLP in 1993, retaining a 1% general partnership interest with LP interests dispersed among his son and his grandsons' trusts, with substantial restrictions. He funded the FLP with Erie stock worth $80 million, which increased to $318 million over the next seven years. The partnership distributed 92% of Erie dividends, with appropriate adjustments to the partners' accounts, and the Blacks never dipped into the assets for their own expenses.

Mr. Black died in 2001 and Mrs. Black followed soon after. The IRS assessed deficiencies totaling over $83 million on their estate tax returns. The parties resolved all the valuation issues prior to trial, leaving only the Sec. 2036(a) issue; i.e., whether the stock transfers were bona fide, for a legitimate non-tax purpose. The taxpayer claimed the following in support:

- The FLP's net asset value increased dramatically through active investment according to Mr. Black's "buy and hold" philosophy;

- The transfer restrictions successfully prevented Mr. Black's son from dissipating his assets in divorce and his grandsons from reaching their stock, even when their trusts terminated; and
- The Black family's consolidated position allowed it to maintain a seat on the Erie board.

The taxpayer also cited *Estate of Schutt v. Comm'r* (T.C. Memo 2005), in which the Tax Court validated a FLP for its "unique circumstances"—primarily its pooling of assets according to the founder's investment philosophy, to preserve them against claims from creditors, divorcing spouses, and irresponsible heirs. The IRS tried to distinguish *Schutt* by claiming that Black's concerns for his Erie holdings was either "ill-founded" or insignificant. The court was persuaded by the precedent, however, and the similar "unique" facts of this case. Moreover, the FLP respected partnership formalities, including appropriate adjustments for contributions and distributions. Accordingly, the court held that the fair market value of Mr. Black's FLP interest, rather than the fair market value of the underlying Erie stock, was includable in his gross estate.

Exit Planning Made Easy—with the Aid of a Good Business Appraiser

Credentialed business appraisers have a valuable but often overlooked function: to serve as financial facilitators for privately held and/or family-run companies that are contemplating succession. Exit planning typically involves dealing with the tough questions of estate planning, asset values, the age and health of current owners, and the passing of substantial management responsibility to the next generation—who may or may not be ready to take on such a heavy mantle (even if they do want the wealth).

A good succession planner consultant will tackle these sensitive issues up front—while the business is still running smoothly and everyone is in a good position to discuss the options and opportunities. By bringing the entire process to fruition, the business appraiser can help the family avoid personal and financial disasters in the future.

The critical questions. In particular, business succession brings together traditional M&A planning with "key" employee and family considerations, along with buy-sell agreements and related appraisals. Exit planning strategies begin with the broad question: What is the business worth? The discussion branches out into three typical alternatives, each with its own specific issues:

1. *Sell the business*. What are the possible profit motives and value enhancement? What are the potential tax strategies and consequences?
2. *Sell to employees.* Smaller, professional service companies have different concerns—and different layers of organizational and administrative experience—than larger operating companies.
3. *Family transfer.* Gift and estate tax strategies are implicated here; planning fundamentals include tax consequence, structured vehicles for gifting or transferring the assets; and potential valuation discounts.

In addition, business owners will face some version of the following questions as the process moves forward:

- *What if the business has no significant value?* This is a disappointing conclusion, but a SWOT analysis (strengths, weaknesses, opportunities, threats) can help identify value-creating areas and places for improvement.
- *Asset or stock sale?* Or does an installment sale make sense, to spread the tax consequences over time? For an operating business, would a SARS plan (stock appreciation rights) work? What about an ESOP? What about recapitalizing the business by issuing more stock and then redeeming the founding shareholders' equity?
- *Internal transfer?* If the owner wants to pass the business onto key employees, consider how they might structure a buy-in that will "incentivize" new partners while providing sufficient retirement for the owner/older partners, and how they might maximize retiring partners' return without burying the succeeding owners in debt.
- *Family transfer?* How can the owner pass the business to the next generation at the lowest possible transfer/tax costs? How do specific gifting plans and estate options work? What about installment sales of minority shares? How do minority/marketability discounts come into play?

All three tracks end, more or less, in a clear, carefully-crafted buy-sell agreement, for which an accredited business appraiser is ideally suited and indispensible. A buy-sell should balance a number of interests, including the continued viability of the business; the needs of the affected (departing) principals and their families; and the needs of the remaining principals. On balance, the paramount concern must be the continued economic viability and health of the enterprise. Appraisers quantification of value will support the best approach that ultimately works to the advantage of all parties and their financial counselors.

Possible pitfalls in succession plans. Like taxes, most business owners don't want to think about death or divorce or other painful issues. Similarly, they don't want to discuss the "death" of their own businesses. A good business succession planner will do everything possible to ease the owner's pain all the way through the process. This means permitting the owners to:

- Leave the company on their own terms and timetable and not as the result of external, unexpected pressures or sudden deadlines;
- Realize the full value of the business and all their hard-earned wealth, minimizing the impact of transfer and estate/gift taxes;
- Retain control of the situation by entertaining a variety of exit options;
- Suffer the minimum of psychological stress and family conflict;
- Watch a lifetime of work come to a fulfilling, profitable finish; and
- Guarantee the continuity of the business.

Exit planning can be time consuming—and most owners are buried in day-to-day operations and management. The planning process can appear complex and costly. But a financial facilitator can help owners understand the tremendous return on investment that solid exit plans provide. Nothing feels better than bringing the entire organization and family together in a unified plan, and knowing that your business will keep bringing them rewards long into the future.

Ten Steps to Value Law Firm Contingency Cases

***Weinberg v. Dickson-Weinberg*, 2009 WL 3294784 (Hawaii App.)(Oct. 14, 2009)** On her appeal of the divorce from her lawyer husband in Hawaii, a wife asked two questions, which have important implications for other state jurisdictions:

- Has the majority rule on the disposition of goodwill in divorce resulted in "gross undervaluations of countless successful businesses" simply because their "fortunate owners" happened to be professionals?
- Does the majority rule properly hold that a law firm professional's pending contingency-fee cases are marital property and subject to division and distribution on divorce?

Healthy plaintiff's practice. At trial, the husband's expert used the asset approach to value the sole proprietorship's appreciation during the marriage. After choosing the separation date as the most "practical," he did not include three contingency cases that settled soon after (but prior to trial), netting over $1.1 million in fees. He also excluded any pending but unliquidated contingency fee cases, due to their speculative nature. Finally, the expert excluded professional goodwill, citing the controlling case in Hawaii (which follows the majority rule on distinguishing enterprise from professional goodwill, finding the former is marital property but the latter is not). He found the practice value had appreciated by only $54,000. The wife did not present a valuation expert, and the trial court adopted the husband's values, setting the stage for appeal.

As a first matter, the appellate court declined the wife's invitation to abandon the majority rule concerning goodwill. The valuation of contingency fee cases, however, was an issue of first impression. "It is well-accepted that hourly-fee contracts for attorney services constitute divisible marital property," the court began (citations omitted). "Like any other receivable, they should be discounted by expenses of collection and a reasonable bad debt percentage." Similarly, a contingency fee settlement or verdict recovered before an attorney's divorce trial is "universally regarded" as marital property to the extent that the attorney's work occurred during the marriage.

Pending contingency fee cases are more problematic, specifically because they defy an accurate value at the time of distribution. For this reason, a few jurisdictions decline to classify a contingent fee contract as divisible marital property (e.g., GA, PA, and IL). The potential breach of attorney-client privilege and ethical prohibitions against fee-splitting between lawyers and non-lawyers is also a concern. Generally, however, these same courts permit the use of contingency fee arrangements in determinations of income and support. By contrast, the majority of courts now hold that unliquidated contingency fee arrangements constitute marital property and are divisible (e.g., AK, AR, CA, CT, MN, NJ, WV, and WI.) These courts retain continuing jurisdiction to distribute fees as received and pursuant to an equitable formula, similar to pension divisions.

In this case, the husband's expert erred by valuing the law practice as of the separation date when state law required values as of the trial date. Thus he (and the trial court) should have included the $1.1 million in fees that the husband received in early 2006.

Ten steps for valuing contingency fees. In remanding the case, the Hawaii court adopted the majority rule regarding contingency cases. However, since state law prohibits family courts from maintaining jurisdiction for more than a year after divorce, its ruling might lead to intentional collection delays by an attorney spouse. To resolve this problem, the court endorsed the following 10-step, work-in-progress (WIP) analysis for law firm contingency fee matters:

1. Identify the outstanding cases at the valuation date.
2. Estimate the average fee per case, net of direct expenses.
3. Assess the success rate or "batting average" of the firm.
4. Determine/estimate the percentage overhead per case.
5. Multiply the number of open cases (step 1) by the net average fee per case (2) by the batting average (3) less the percentage overhead (4) to obtain the estimated future profit attributable to the WIP.
6. Estimate the average length of time of open cases (i.e., compare the start date and recovery date for a number of cases).
7. Calculate the estimated date of completion for each case by comparing its start date to the average length of the case (step 6).
8. Select an appropriate discount rate to apply to the present value calculations.
9. Determine the present value of the WIP by discounting the estimated future profit (step 5) by the discount rate (8) using the estimated completion date per case (6) as a time factor.
10. Add the value of the WIP to the firm's adjusted balance sheet, with additional adjustments for cash, investments, and other assets/expenses.