

TAX COURT CASE UPDATE

Citation:

Estate of Diane Tanenblatt, et al. v. Commissioner, T.C. Memo 2013-263, November 18, 2013.

Overview:

The Tax Court ruled on various concepts involved in valuing a decedent's LLC interest, including the effect of a clause in the LLC agreement that restricted the transferability of the interest.

The Facts:

Code Section 2038(a) includes the value of all interests in property transferred before death in a decedent's gross estate, where on the date of death, the transfer was subject to change through the decedent's exercise of a power to "alter, amend, revoke, or terminate the transfer."

Ms. Tanenblatt ("the decedent") transferred her 1/6 interest in a limited liability company ("LLC") to a trust, retaining the power to revoke the transfer. She passed away on February 23, 2007.

Membership of the LLC was divided among three family groups, and transfers of membership interests outside of those groups were restricted. A non-family member transferee could not become a member of LLC without the unanimous approval of all of the members. A non-family member transferee who received a membership interest but who did not become a member was entitled to receive the distributions and allocations of profits and losses as an assignee and had no right to participate in the management and control of the LLC. The decedent was a member of one of the family groups when she transferred her interest to the trust. The LLC's only significant asset was a commercial building in New York City.

On the estate tax return, the estate valued the LLC interest based on an appraisal that used an income capitalization method to determine that the net asset value of the building was \$19,960,000. The appraiser then added the value of the LLC's other assets, subtracted the LLC's liabilities, and deducted a 20 percent discount for lack of control and a 35 percent discount for lack of marketability. The total of the discounted net assets was then multiplied by the decedent's interest of one-sixth. The resulting amount, \$1,788,000, was included in the gross estate under Code Section 2038(a). In its pleadings in the Tax Court case, however, the Estate argued for a lower valuation.

The IRS's position was that the \$19,960,000 asset value was accurate but that the discounts should have been 10 percent and 26 percent, respectively.

Discussion:

The estate had two objections to the IRS's valuation. First, it objected to the fact that the value of the LLC was defined exclusively by reference to its net asset value, asserting that "[the] LLC is at least in part an operating company that should be valued giving some weight to [the] LLC's

earnings and/or distributions." Also, it argued that given that the hypothetical purchaser would not have any say in the LLC's decisions to make distributions, to sell the building, or to liquidate, the hypothetical purchaser's primary concern would be historical earnings and distributions.

The Court first cited some points in the estate's favor. It noted that Revenue Ruling 59-60 (1959-1 CB 237) provides that "[i]n general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued." It then said that the LLC undoubtedly provided services to the public, i.e., a fully leased gross rentable area of 77,725 square feet. And although the members of the LLC may have had the future appreciation of the building in mind, the Court said that the LLC managed a going concern provider of services.

But the Court concluded that:

... it had no evidence that an explicitly income-based approach to valuing LLC would necessarily have reached a different valuation conclusion, or what that valuation conclusion would be;

... while IRS's (and the estate tax return's) valuation of LLC was based on the net asset value of LLC's assets, the value IRS used for LLC's principal asset, the building, was based on an income approach. That is, the Estate's appraisal firm projected building income for six years, capitalized the sixth year's income to determine a terminal value, and discounted the resulting income stream to present value, to arrive at \$19,960,000.

Second, the estate said that the IRS should have, but failed to, value the subject interest as an assignee's interest under the willing buyer-willing seller standard prescribed in Regulation §20.2031-1(b). That is, the estate argued that in applying the willing buyer-willing seller standard, the hypothetical willing buyer must be assumed to be a non-family member who would, in effect, be purchasing an assignee's interest since he could not become a member of the LLC without unanimous approval of all membership interests.

The Court began its analysis of this argument by agreeing with the estate that a "member's" interest is more valuable than an equivalent percentage interest of an "assignee" because the member's interest can participate in management and control of the LLC. However, it then went on to say that on the date of death, the subject interest was a member's interest. The holder of that interest, at that time, enjoyed fully the benefits and burdens of being a member of the LLC, including his or her inability to transfer all of those benefits and burdens to a non-family member transferee. The hypothetical willing buyer and hypothetical willing seller would understand a member's interest to be so restricted, and would take that restriction into account in their negotiations of what a member's interest was worth. The IRS's valuation considered such restrictions imposed on transferability as a factor in its marketability discount analysis.

The Court also pointed out that the net asset value that the IRS used was the same net asset value used by the estate on the estate tax return. It then noted, citing *Estate of Hall* (92 T.C. 312 (1989)), that "[v]alues or discounts reported or claimed on an estate tax return may be considered admissions and, to some extent binding or probative, restricting an estate from substituting a lower value without cogent proof that those admissions are wrong."

Conclusion:

The Tax Court accepted the IRS's valuation of the LLC interest.