TAX COURT CASE UPDATE

Citation:

Estate of Ellen D. Foster, et al. v. Commissioner, No. 11-73400 (9th Circuit), March 26, 2014.

Overview:

The Court of Appeals for the Ninth Circuit has affirmed the Tax Court's estate tax valuation determinations, including a determination that claims against the estate did not create valuation discounts for certain of the estate's assets and did not meet the relevant tests for deductibility as liabilities of the estate.

The Facts:

The decedent, Ellen Foster, and her husband, founded Foster & Gallagher, Inc. ("F&G"), a mail-order horticulture business. In 1995, Mr. Foster and several other shareholders sold the majority of their stock to F&G's employee stock ownership plan ("ESOP"). The company financed the purchase by borrowing $70 million on an unsecured basis from four lenders. One of the lenders, U.S. Trust, was hired as the ESOP's trustee.

Mr. Foster contributed his roughly $33 million of sales proceeds to his revocable trust. He died on July 11, 1996, and the revocable trust was divided into three marital trusts. Northern Trust was the co-trustee of the marital trusts.

In 1998, F&G began experiencing financial trouble. Its revenues and earnings steadily declined, causing it to be in violation of the financial covenants of the ESOP loans. The ESOP lenders (including Northern Trust) sought to restructure the loans to gain a security interest in the company's assets. F&G went bankrupt in 2001. Just before the bankruptcy filing, beneficiaries of the ESOP filed suit (the Keach lawsuit) alleging breaches of fiduciary duty committed by U.S. Trust and Mr. Foster (with the decedent named as a defendant as executrix of Mr. Foster's estate) in connection with the ESOP transaction. They also sought restitution against the decedent and Northern Trust as co-trustees of the marital trusts, and requested the imposition of a constructive trust over the assets held by the decedent as executrix of Mr. Foster's estate and co-trustee of the marital trusts.

To avoid potential liability to the ESOP plaintiffs for distributions from the marital trusts, Northern Trust unilaterally froze the decedent's right to withdraw the principal of marital trust #3.

The ESOP beneficiaries lost in district court, but appealed on April 9, 2004. The decedent died on May 15, 2004 while the appeal was pending. Her estate tax return showed values of roughly $1 million for marital trust #1, $35.5 million for marital trust #2, and $14 million for marital trust #3. The estate also listed a liability related to litigation against each trust in these amounts: $286,100 for marital trust #1, $10,373,046 for marital trust #2, and $4,017,769 for marital trust #3.

The case went to the Tax Court. At trial, the estate argued for discounts due to litigation hazards (with respect to the Keach litigation) and lack of marketability (because of the freeze), and alternatively, it argued that it had a liability as a result of the Keach lawsuit.

The Tax Court ruled against all of the estate's arguments. As to the litigation hazards argument, it said that a willing buyer would not have insisted on a discount on the assets of the marital trusts because the Keach lawsuit could not have affected a buyer's rights. As to the lack of marketability, it said that the freeze may have prevented the decedent from selling any of the assets of marital trust #3, but it did not affect the value of those assets. And as to the estate's liability resulting from the Keach lawsuit, the court found that the estate failed to establish the amount of the liability with reasonable certainty, as required by the applicable regulation.

Conclusion:

The Ninth Circuit, using much the same reasoning as the Tax Court, affirmed all of the above-noted Tax Court holdings. It said that the Tax Court did not err in declining to apply discounts for hazards of litigation or lack of marketability. The plaintiffs in the Keach lawsuit did not seek to recover specific, unique assets from the defendants, and the Keach lawsuit did not cloud the title of the trust assets. Because a hypothetical buyer of the trust assets would not become a defendant in the Keach lawsuit, the Tax Court properly rejected any hazards of litigation discount.

And, the Ninth Circuit said, the Tax Court correctly observed that the freeze applied to Ellen Foster, not the underlying trust assets. And it noted that the freeze was "loosely enforced." It said that the Tax Court properly rejected the estate's alternative argument that the estimated date-of-death value of the Keach lawsuit was deductible as a claim against the estate. In view of the sharp discrepancies in the expert valuations of the lawsuit, the Tax Court correctly concluded that the lawsuit's estimated date-of-death value was not ascertainable with reasonable certainty.

The Ninth Circuit also rejected the estate's argument that the Tax Court erred in valuing the marital trusts' assets, rather than Ellen Foster's beneficial interest. The estate expressly acknowledged on its tax return that "the assets of all three marital trusts are includible in the Estate of the decedent," and its expert provided valuations of the assets in the marital trusts. Because the estate proffered evidence of the value of the underlying assets, it could not then argue that the Tax Court erroneously considered the value of those assets.