



Buy-Sell Provision on Book Value ‘Too Vague to Cure’

Ehlinger v. Hauser, 2008 WL 2833219 (Wis. App. IV Dist.)(July 24, 2008)

Two business colleagues took a 50% share in a manufacturing partnership that employed 30 people. After seven years in business, one of the partners fell ill with Parkinson’s disease. In the event of a partner’s disability, the partnership’s buy-out provisions permitted the firm to purchase his stock at the greater of \$350,000 or “book value.” The agreement did not define “book value” or the methods by which it should be determined.

Financial statements don’t comply with GAAP. The partners did agree that if a sale of the partnership took place, it would occur after the fiscal year ending March 2001. In June of that year, the remaining partner (Hauser) sent the ailing partner (Ehlinger) a letter invoking the disability buyout provisions and offering to purchase his shares for \$431,400, an amount based on “book value” of the partnership. The departing partner was given the opportunity to inspect the books and records of the business. He also attended a shareholders meeting, at which he moved for an independent audit to determine the partnership’s value. Hauser declined to second the motion, and subsequently closed on the purchase of Ehlinger’s shares—which Ehlinger refused to accept or attend.

Ehlinger filed suit for a judicial dissolution of the partnership and a declaratory judgment that the buyout provisions were unenforceable for lack of essential terms, including the definition and specific methods pertaining to “book value.” Even if the term “book value” was not ambiguous, he said, discrepancies among the partnership’s books and records rendered them unreliable. The remaining partner (Hauser) claimed that his exercise of the buyout provisions was conclusive.

The trial court first sought to determine the book value of the departing partner’s shares. It adopted the parties’ valuation date and their stipulated definition (“assets minus liabilities”), but whereas Hauser

urged the court to use the 2001 financial statement to calculate book value, the departing partner claimed this information was “self-serving” and “suspect” due to its non-conformity with generally accepted accounting principles (GAAP).

Neutral expert also finds problems. The court appointed an independent CPA as special magistrate to determine book value “using generally accepted accounting principles” and to report any inconsistencies, including departures from GAAP.

The special magistrate was able to verify GAAP compliance with all records but those pertaining to inventory, accounts, depreciation, and corporate minutes. The partnership claimed its computer system could not provide the back-up detail, and thus the magistrate could not verify GAAP compliance. The trial court concluded the parties’ contractual term was “too vague to cure.” Book value could mean “anything from simple adoption of the year end statement to an audited determination,” it held, and entered a judgment for dissolution. The remaining partner appealed—but the appellate court confirmed, finding that due to the missing information, the partnership’s book value could not be determined as of the stipulated date.

IRS Deems Another FLP as ‘Indirect Gift’

Gross v. Comm’r, 2008 WL 4388277 (U.S. Tax Ct.) (Sept. 29, 2008)

For the second time in recent months, the IRS has challenged a Family Limited Partnership (FLP) under IRC Sec. 2511 and related Treasury Regulations as an indirect gift of assets from the founder to family members/limited partners.

After her husband’s death in 1996, a wealthy New York investor decided to establish an FLP to encourage her two daughters to preserve the family’s fortune.

Continued on next page...

The widow also wanted to retain control, however, and decided with her daughters that she would be sole general partner (GP) of the FLP, with exclusive power to make distributions. The daughters agreed to substantial transfer restrictions on any LP interests they received.

On July 15, 1998, the widow filed a certificate of limited partnership for the FLP (Dimar Holdings, LLP) and followed other New York filing and publication requirements. Shortly afterward, she contributed \$100 to the partnership and the daughters each contributed \$10. From October through December 4, 1998, the mother transferred over \$2.15 million in common shares of well-known, publicly traded companies to the FLP. Eleven days later, on December 15, 1998, she transferred a 22.25% limited partnership interest to each daughter. On that same day, the parties executed the partnership agreement, which imposed severe transfer restrictions on the LP interests and maintained the mother as sole GP.

In her 1998 gift tax return, the mother valued each of the 22.25% LP interests at \$312,500, after application of a 35% combined discount for lack of marketability, lack of control, and minority interest. (The court does not say whether an independent appraisal accounted for the values, but only that they appeared in a schedule attached to the return.) The IRS asserted a deficiency of \$120,583, based on valuing the gifts at a reduced discount.

The importance of following partnership formalities. To form a limited partnership, New York law states that the general partners “shall” execute a partnership agreement and a certificate of limited partnership. Still, in a related provision, the statute says the LP is formed on the filing of the certificate and requires publication within 120 days. The IRS construed these provisions together, arguing that the execution of a partnership agreement is a condition precedent to formation of an LP.

However, the taxpayer claimed that she properly formed the FLP as a limited partnership in July 1998, when she filed the certificate and agreed with her daughters on its essential terms. In the alternative, if the FLP failed to establish a limited partnership, it nevertheless qualified as a general partnership under New York law in July.

The Tax Court found that neither party made a compelling argument for its claims regarding

the timing for LP formation. However, it agreed with the taxpayer that New York law recognized a general partnership in July 1998, when all of parties agreed to the essential terms, made their respective contributions, and the taxpayer began contributing her securities portfolio.

Holman is controlling on indirect gifts. The IRS maintained that the taxpayer made indirect gifts to her daughters because, under IRC Sec. 2511 and applicable case law, she contributed the securities to the FLP for inadequate consideration. In other words, in making the series of stock transfers to the FLP, the taxpayer received increasing GP interests in return. However, after completing the transfers on December 4th and creating the 22.25% LP interests for her daughters on December 15th, she effectively reduced the value of her GP interest to 55.50%—or less than adequate consideration for the original contribution. The IRS also urged the court to find, under the “step transaction” doctrine, that the events were so intertwined that they composed a single transaction, such that formation and funding effectively occurred on a single day.

The Tax Court, in an opinion by Judge Halpern, relied on the recent *Holman v. Comm’r* (May 2008) (also by Judge Halpern). In *Holman*, the court found six days from the funding of an FLP with Dell stock to creation of the limited partnership (LP) interests was sufficient to disqualify the transfer as an indirect gift. The reason: The taxpayers bore a “real economic risk” that the partnership’s value would change during that time. “We reach the same result here,” the court concluded, when eleven days elapsed between the taxpayer’s last transfer of securities and her gifts of LP interests to her daughters; and when—as in *Holman*—the assets comprised common shares of well-known public companies. “The form of the transactions here...accords with their substance.”

IRS agreed on discounted value. Prior to trial, the parties stipulated that—should the court find the taxpayer to have made gifts of LP interests to her daughters on December 15, 1998—then she’d correctly reported their values on her gift tax return, including the 35% combined discount. Although the court found only that the taxpayer made gifts of partnership interests (not necessarily LP interests) on December 15, it accepted the parties’ stipulation. The taxpayer also offered an expert at trial, who testified that whether the court found the daughters’ interests to

be in a general or limited partnership, they were each worth only \$277,868, given the substantial transfer restrictions.

The IRS did not offer any expert to rebut this testimony—and the court accepted it in support of the parties' stipulation, concluding that the fair market value

Using a Joint Appraiser To Advantage in Divorce

Parties are increasingly seeking ways to reduce the cost and conflict of divorce. Many attempt to streamline the process by retaining a joint expert/valuator to appraise the marital business and/or business interests. Indeed, there are numerous benefits. Consider, for instance, that without a joint appraisal, many non-business owning spouses or those without direct access to marital funds would not be able to afford any expert in the case.

Moreover, a joint expert is also likely to get better access to documents and other evidence than an expert who has been retained by one party or another. Finally, a joint expert can often take on the role of creative problem solver, coming up with financially efficient, resourceful solutions. The parties and their attorneys frequently view the joint appraiser as more independent and objective, and can use the joint expert to expedite mediation and settlement.

The joint appraiser is particularly suited to smaller cases that concern sole proprietorships or family-owned businesses, when two experts would most likely reach similar conclusions of value. Parties in the smaller cases will not often have the funds to hire specialists or consultants—and conversely, where the parties do have such funds, a joint expert may not work to their advantage.

Up-front framework. Once the parties have decided to take this route, it is important to work toward creating a framework for the engagement by taking steps to:

- Define the scope of the engagement and determine whether the expert will provide ancillary services, such as forensic investigation, income determination, and accounting for separate property.
- Establish a protocol for communications between the expert and counsel and the expert and the parties.

- Establish a protocol for communications between the expert and the court.
- Establish a protocol for communications between the expert and any consultant, specialist, or rebuttal expert that the parties may hire.
- Establish a timeline and procedure for the document production process, especially who will provide the documents and what they will provide.
- Provide a methodology to enforce the cooperation of the parties and a means of recourse for the expert if requested information is not forthcoming.
- Discuss and define the applicable standard of value.
- Institute a procedure for providing draft reports and receiving comments from attorneys and the parties.
- Determine the format of the final work product and whether the expert will provide a summary or detailed report
- Establish a procedure to compensate the expert, including the amount of a retainer, and his/her recourse for delinquent payments.

There are, of course, common problems in divorce cases. Just because the parties have retained a joint expert does not immune the process, or the appraiser, from the same challenges that can frustrate any divorce proceeding. Investing the effort to establish a framework for the engagement can reduce these frustrations. In addition, if the attorneys and both spouses support the retention of a joint appraiser, they will have more confidence in the process.

Attorneys avoid any pitfalls by clearly explaining to their clients the differences between retaining a sole expert and a joint expert. This will help clients from feeling “betrayed” later on in the case—when, for example, the appraiser may spend more time with the business-owning spouse to obtain information and financial records; or when the appraiser's opinions conflict with the owner's perception of the business' value.

Key is to not only become acquainted not only with appraisers who have experience as joint experts, but also those who also have some mediation or alternative dispute resolution training, as they may prove to be

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the most efficient joint experts. The emerging field of collaborative law in many jurisdictions also utilizes the joint expert process. Many mediators/arbitrators are taking advantage of the joint appraisers as well, to reduce the conflict and cost of divorce cases.



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