

California (Los Angeles)

James S. Rigby ABV, ASA
213.362.9991

Erich Z. Sylvester JD., ASA
213.362.9991

California (Oakland)

John J. Mayerhofer
FACHE
510.531.2943

California (Silicon Valley)

Robert T. Lanz
408.777.2914

Florida (Tampa)

Michael J. Mard ABV, ASA
813.985.2232

Steven Hyden ASA
813.985.2232

Florida (Ft. Lauderdale)

Michael A. Crain ABV, ASA, CFE
954.382.2201

Georgia (Atlanta)

James R. Hitchner ABV, ASA
404.873.6633

Illinois (Chicago)

Michael J. Mattson
773.769.3045

Iowa (Des Moines)

Terry J. Allen ABV, ASA
515.953.4498

Massachusetts (Boston)

Stephen J. Bravo ABV, ASA
508.872.6060

Missouri (Kansas City)

Terry J. Allen ABV, ASA
816.373.3340

Missouri (St. Louis)

Ralph Ostermueller ABV, ASA
314.965.5921

Montana (Great Falls)

John R. Gilbert ABV, ASA
406.453.1800

Please contact us via email:

info@fvginternational.com

Tax Valuation E-Flash

Mark and Michele Senda, T.C. Memo 2004-160, July 12, 2004

In a "bad facts case," the Tax Court determined that gifts of FLP interests to children were indirect gifts of underlying stock.

The taxpayers set up two FLPs in 1996 and 1999. They formed these entities with their children as limited partners. At some point in time, which point is disputed, the taxpayers transferred shares of MCI-Worldcom to the partnership and made gifts of FLP interests to the children.

The taxpayers argued that they made gifts of valid limited partnership interests and the partnerships should not be disregarded. They further argued that they did not shift economic value to the children when the stock was contributed to the partnerships. The IRS did not dispute the validity of the partnerships or argue that the partnerships lacked economic substance. The IRS did argue that the "transitory allocations to petitioners' capital accounts, if such allocations even occurred at

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all, were merely steps in integrated transactions intended to pass the stock to the petitioners' children in partnership form."

The Tax Court found that an indirect gift of stock had occurred rather than gifts of limited partnership interests, noting the following:

- It was unclear if the taxpayers' contribution of stock to the partnerships was ever reflected in their capital accounts,

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- The children received their partnership interests in exchange for oral accounts receivable that had never been documented in writing and remained unpaid at trial,
- The partnership agreement required preparation of annual financial statements and an annual meeting of the partners, neither of which took place,
- The taxpayers paid all legal fees and filing costs for the formation of the partnerships, costs that were never reimbursed by the partnerships,
- “It is apparent from petitioner’s evasive testimony and from the total record that petitioners were more concerned with ensuring that the beneficial ownership of the stock was transferred to the children in tax-advantaged transactions than they were with the formalities of FLPs,” and
- The taxpayers presented no reliable evidence that they contributed stock to the partnerships before they transferred the partnership interests to the children.

There was no dispute as to the value of the stock or the partnership interests. Shortly before trial, the IRS accepted minority discounts of 5.88%, 15.44%, and 17.12% for the three relevant dates. A marketability discount of 35% was accepted for all the gifts.

Terrible Outcome for Taxpayers

As a result of sloppy handling of the partnership, the taxpayers will owe Federal gift taxes of almost \$500,000 for gifts of MCI-Worldcom stock whose value subsequently declined by almost 90%.