Estate of Murphy vs. United States, U.S. Dist. Ct. W.D. Ark. El Dorado Division, Case No. 07-CV-1013 (October 2, 2009)

Total Taxpayer Victory in FLP Case Involving §2036, Rule 144/Blockage Discounts, FLP Discounts, and Graegin Loan

October 2009

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Synopsis

Among other assets, decedent owned substantial interests in a publicly traded oil company (he served as CEO and Chairman of the Board), a timberland and farmland company, and a bank. Decedent formed an FLP to centralize management and protect against dissipation of those family assets, and transferred his interests in the three companies (worth about $90 million) to the FLP (directly or through the LLC that was the general partner). (The concern about dissipation arose because two of decedent's four children had pledged and sold many of the family assets that had previously been given to them. The other two children shared decedent's philosophy and participated in the FLP planning and operations.) Decedent retained assets worth about $130 million. Decedent, individually and as trustee of several revocable trusts, acquired a 96.75% limited partnership interest. A new LLC, owned 49% by decedent and 51% by two of his children, held a 2.25% general partnership interest. At decedent's death, he owned a 95.25365% limited partnership interest in the FLP, and the LLC owned a 2.28113% general partner interest.

The transfer to the FLP satisfied the bona fide sale exception to §2036.

The value of the limited partnership interest is calculated by first determining the net asset value of the stock in the three companies owned by the FLP, taking into consideration Rule 144 and blockage discounts (applying the taxpayer's expert's discounts of 5%, 10.6%, and 1.3% for the three corporations) and of a timber and farm plantation. Second, the value of the 95.25365% limited partnership interest is determined by applying a 12.5% lack of control and 32.5% lack of marketability discount, for an overall combined discount of about 41% of the net asset value. The value of decedent's 49% interest in the LLC, which is the general partner of the FLP, is determined by applying two levels of discounts; (i) the LLC's 2.28113% general partner interest is valued with a 20% lack of control/lack of marketability discount, and (ii) the estate's 49% interest in the LLC is valued with a lack of control discount of 11.1% and a lack of marketability discount of 32.5%. The overall discount of the tiered entity is 52% of the net asset value.

The estate is allowed an estate tax deduction for all of the interest on a 9-year Graegin note for amounts borrowed from the FLP and for the interest actually paid on another note. The proceeds of the loans were used to pay federal and state estate taxes.

Basic Facts

(1) Decedent served as the CEO and Chairman of the Board of Murphy Oil Corporation, a publicly traded company, and owned significant shares in the company. He also owned about 3% of the stock of Deltic Timber Corporation (another NYSE corporation), which operates farm, timber and real estate businesses. In addition, he owned about 0.37% of a bank (that later merged with Bancorp South, Inc.). He was involved in the management of all three companies. (Decedent's interests in those three companies are referred in the opinion as the family's "Legacy Assets.")

(2) Two of decedent's four children had sold and pledged various family assets previously given to them or to trusts for their benefit. Decedent's attorney recommended that he transfer the family's Legacy Assets to an FLP "to accomplish his goal of pooling the family's Legacy Assets together under centralized management and to protect those assets from being dissipated."

(3) On February 19, 1998, after various planning sessions with his other two children (one of whom was represented by an attorney), decedent contributed his interests in the three companies (held individually and as trustee of several revocable trusts) worth about $89 million to an FLP, for a 96.75% limited partner interest (and an additional 1% limited partnership interest that he allocated to a college as a charitable gift). The 2.25% general partner interest was owned by an LLC that was owned 49% by decedent and 51% by two of his children. (Decedent and the

children contributed about $2 million of the Legacy Assets to the LLC, which it contributed to the FLP for its general partner interest.)

(4) This planning was part of a process of decedent turning over management of family assets to the next generation. The two children who shared his business/investment philosophy (i.e., a buy and hold philosophy) became actively involved with the management of the FLP and its employees. The youngest son continued serving on the Board of Directors of the three corporations comprising the family's Legacy Assets. The FLP purchased timberland and farmland (and the two children prevailed in a disagreement with decedent over how many acres to purchase) and made significant capital improvements to the plantation. The partners met six to eight times a year to discuss partnership business.

(5) The FLP made only two distributions during decedent's life: (1) a pro rata distribution to partners in one year to cover the partners' federal taxes attributable to the FLP; and (2) a distribution to decedent of stock in another company (so the company could convert to an S corporation), which distribution reduced decedent's percentage interest and capital account in the FLP.

(6) Decedent made annual exclusion gifts of FLP interests to his children, their spouses, and eight grandchildren until his death.

(7) Decedent died on March 20, 2002. By that time, the assets in the FLP had grown from $91 million to about $131.5 million.

(8) The estate tax return reported decedent's 95.25365% limited partner interest in the FLP at $74,0082,000 (using a 41% discount).

(9) The estate sold its shares in a bank, but because the stock had declined substantially in value (and assets in the FLP had appreciated substantially), the estate had a $16 million shortfall to pay estate taxes. The estate borrowed funds to raise needed cash, including an $11 million 9-year "Graegin note" from the FLP, secured by a 14.36% limited partner interest in the FLP. (The estate also borrowed $5.4 million from a Family Trust but did not claim an estate tax interest deduction with respect to that loan.)

(10) About three years after the estate tax return was filed, the IRS issued a Notice of Deficiency for $34 million, alleging that the estate undervalued various assets, and that the FLP assets were includable in the estate under §§2036(a)(1) and 2036(a)(2). The estate borrowed $41 million from trusts created in 1956 to pay the added tax and interest (this was documented by a note with a variable interest rate that could be prepaid — so it was not a Graegin note). The estate paid the added tax and interest on December 20, 2002 and filed a Claim for Refund the same day.

Holdings

(1) The transfers to the FLP qualified for the bona fide sale for full consideration exception to §2036.

(2) The FLP is valued based on net asset value with appropriate lack of control/marketability discounts. The net asset value of the interests in the three corporations is determined with Rule 144/blockage discounts of 5%, 10.6% and 1.3%. The estate's 95.25365% limited partnership interest is valued by applying a 12.5% lack of control discount and a 32.5% lack of marketability discount, for a combined seriatim discount of 41% (the discounts used by the estate's expert).

(3) The estate's interest in the LLC is determined after applying two levels of discounts: (1) a 20% lack of control/marketability discount for the general partner interest owned by the LLC, and (2) a 11.1% lack of control and 32.5% lack of marketability discount (a combined discount of 40%)

for valuing the estate's interest in the LLC. The overall combined discount was 52% (again, being the discount used by the estate's expert).

(4) Interest on the full term of the 9-year Graegin note is deductible and interest paid to date on the other note is deductible.

Analysis

(1) Section 2036 Bona Fide Sale For Full Consideration Exception.

(a) Bona Fide Sale. The bona fide sale element of the exception in §2036 requires a transfer in good faith with "some potential benefit other than the potential estate tax advantages that might result from holding assets in the partnership form" (quoting Estate of Korby and Estate of Thompson). The court lists the following factors in concluding that the bona fide sale requirement is met.

- Purpose — Purposes of the FLP included pooling "the family's Legacy Assets into one entity to be centrally managed in a manner that was consistent with Mr. Murphy's long-term business/investment philosophy." (The IRS argued that holding assets long term without active management is not a legitimate non-tax purpose. The court responded that the Estate of Schutt case held that implementing a buy and hold investment strategy is a legitimate non-tax purpose, and that the youngest son was actively involved in management of the three Legacy Asset companies.)
- Management and Operation — The youngest son was actively involved in the management of the Legacy Assets, and the FLP purchased and managed property consistent with the goal of acquiring and maintaining the family's historical assets.
- Retained Assets — Decedent retained $130 million of assets to support his lifestyle.
- Formalities — Decedent did not treat the FLP assets as his own and did not commingle his assets with FLP assets.
- Not "Standing on Both Sides" — The two children involved with the FLP took an active role in the formation of the FLP, with the daughter being represented by her own attorney, so decedent "was not effectively standing on both sides of the transaction."

(b) Full Consideration. The case followed the Kimbell analysis of the full consideration requirement. It is met because 1) the interest in the FLP was proportionate to the value of the assets contributed, 2) the value of each partner's contribution was credited to the partner's capital account, and 3) on termination or dissolution of the partnership, the partners are entitled to distributions from the partnership in amounts equal to their respective capital accounts. The IRS argued that the Kimbell test is not the appropriate test. The court rejects that argument, simply saying that it is "not persuaded."

(c) §§2036(a)(1) and 2036(a)(2). Because the §2036 exception applies, the court does not discuss whether §2036(a)(1) or 2036(a)(2) would have applied, but for the exception. The opinion does not disclose why the IRS reasoned that §2036(a)(2) would apply in this case when decedent only owned 49% of the LLC that was the sole general partner.

(2) Value of Limited Partner Interest.

(a) General Approach. The net asset value approach is used to value the estate's limited partner interest. First, the net asset value of the interests in the FLP's assets is determined.

Second, appropriate lack of control and lack of marketability discounts are applied to determine the value of the estate's 95.25365% limited partnership interest.

The estate's primary expert was Donald Barker (Howard Frazier Barker Elliott, Inc.) and the IRS's primary expert was Francis Burns (CPA International).

[**Observation:** Interestingly, as to each separate value issue, the court considers the positions of the estate's and IRS's experts and picks the expert opinion that it finds the most credible. Unlike many Tax Court cases, the court does not perform its own appraisal analysis to arrive at a value somewhere between the experts' values. Also, it is interesting that for many of the issues, the court concludes which expert's opinion is more credible as to each issue without any explanation of why that that expert's opinion was more credible than the other.]

[**Observation:** It is also interesting that the court uses the estate's expert's opinion for every one of the many valuation issues considered except for one minor net asset value (i.e., the value of timberland in the plantation owned by the FLP).]

(b) Overall Value of Limited Partner Interests. The overall values proposed by each party and the value determined by the court are:

Estate's expert:	$ 74.15 million
IRS's expert:	$106.24 million
Court:	$ 74.50 million

(c) Rule 144/Blockage Discount. Both the estate's and the government's experts agreed that a Rule 144/blockage discount would apply in the valuing the FLP's stock in the three Legacy Asset companies, but they disagreed on the amount of the discount. The court finds the estate's expert more credible because it considered not only the size of the block relative to the daily trading volume, but also (unlike the government's expert) "the volatility of the stock, the actual price change in the stock under recent and preceding market conditions, the company's current economic outlook, the trend of the price and the financial performance of the stock, the trend of the company's earnings and the existence of any resale restrictions on the stock." In addition, the government's expert did not consider SEC sales restrictions on the Murphy Oil stock.

(d) Timberland and Farmland. The one area where the court sides with the IRS is on the value of timberland in the plantation. However, the court finds the estate's expert's valuation of farmland in the plantation to be more credible because the government's appraisal used one comparable that was 75 miles away from the estate's property and because it did not apply a "downward size adjustment" in comparing the estate's farmland (13,481 acres) to the much smaller comparables (1,233 to 4,786 acres).

(e) Lack of Control Discount — 12.5%. Both appraisers determined appropriate lack of control discounts using data from closed-end equity funds. The court finds that the estate's appraiser (who applied an 11% discount) screened the funds and used funds that were most similar to the FLP's equity category. In addition, the estate's appraiser applied a 5% discount even for the large cash/cash equivalents holdings, reasoning that the large cash balance "would be invested in equities or real estate in lieu of the partnership's long-term goals." The estate's appraiser applied a weighted average lack of control discount of 12.5%, and the government's appraiser calculated a 10% lack of control discount. The court applies a 12.5% discount, finding the estate's expert to be more credible.

(f) Lack of Marketability Discount — 32.5%. Both experts used restricted stock studies, but they applied different approaches. The estate's expert calculated a 32.5% lack of marketability discount and the IRS's expert applied a 10% discount. The court prefers the estate's expert's approach, which compared the data "from three studies (FMV Opinions, Management Planning (MPI), and Silber)… to the holding period, relative risk, distributions policy, and transfer restrictions of Mr. Murphy's partner interest. In doing so, Barker realized that the 'holding period' for Mr. Murphy's partner interest was substantially longer than that of restricted stock (one to two years)."

(g) Combined Seriatim Discount — 41%. The combined seriatim lack of control and lack of marketability discount is about 41% (i.e., the value is 87.5% x 67.5%, or 59.0625% of net asset value, representing a discount of 40.9375%).

(3) Value of 49% Interest in LLC General Partner. The estate's 49% interest in the LLC that served as the sole general partner of the FLP is determined using a tiered entity approach. [**Observation:** This is consistent with the result in the 2008 Astleford case, which allowed multiple levels of discounts for a tiered entity. The court does not cite Astleford, or discuss the allowance of the two levels of discounts, but both appraisers agreed with this approach. This seems appropriate particularly in light of the fact that the "subsidiary entity" (i.e., the FLP) was not wholly owned by the "parent entity" (i.e., the LLC).]

First, the LLC's 2.28113% general partner interest is determined and the court without explanation adopts the estate's expert's 20% lack of control/lack of marketability discount (rather than the IRS's expert's 14.5% discount). Second, the court determines the value at the "parent" level of the estate's 49% interest in the LLC. Again, without explanation, the court adopts the estate's expert's conclusion of an 11.1% lack of control discount and a 32.5% lack of marketability discount. (The IRS's expert's same respective discounts were 5% and 10%.) The combined seriatim lack of control and lack of marketability discount is about 40% (i.e., 88.9% x 67.5%, or 60.0075% of net asset value, representing a combined discount of 39.9925%).

The combined two-level discount for the two entities (i.e., the 2.28113% general partner interest inside the LLC and the 49% interest in the LLC) is 52.02%.

In summary:

LLC's 2.28113% general partner interest: 20% discount

49% interest in LLC: 11.1% lack of control discount

32.5% lack of marketability discount

Combined two-tier overall discount: 52.02%

(4) Interest Deduction for Graegin Note and Other Note. The estate borrowed $11,040,000 from the FLP on a 9-year "Graegin" note (i.e., which had a fixed term and interest rate and which prohibited prepayment). The estate also borrowed an additional $41.8 million from a prior trust on a "regular" note (i.e., that had a floating interest rate and that permitted prepayment). The estate sought to deduct the interest on these loans for estate tax purposes.

(a) Graegin Note. "Borrowing money to pay the estate tax of an illiquid estate is a 'necessarily incurred' administrative expense under section 2052" (citing McKee, 72 T.C.M. 324 and Estate of Todd, 57 T.C. 288 (1971)). The full amount of interest over the 9-year period of the Graegin note (i.e., though December 2011) is deductible, based on the 1988 Graegin case, because the total amount of interest is "not vague or uncertain but instead is capable of calculation." The IRS argued that the interest should not be deductible for two reasons.

(i) Self-Created Illiquidity. The interest was not necessarily incurred "because it was the result of an unnecessary estate-tax avoidance transfer" that drained decedent's estate of liquid assets. The court rejects this reasoning, because the FLP was created "in good faith and for legitimate and significant non-tax purposes," and because decedent retained sufficient assets ($130 million) at the time the FLP was created to pay his living expenses and anticipated estate taxes.

(ii) Sale and Distribution from FLP. The FLP could have sold some of its assets and made a distribution of cash to the estate to pay taxes. The court also rejects this argument, reasoning that "[i]f the executor acted in the best interest of the estate, the courts will not second guess the executor's business judgment. *McKee*, 72 T.C.M. at 333."

(b) Regular Note. Because of the floating interest rate and the possibility of early payment of the loan, only the amount of interest paid to date is deductible. [**Observe:** Perhaps the estate has filed a protective claim for refund so that it can deduct any additional interest as it is paid.]

(5) Bench Trial in District Court. The case was tried in a five-day bench trial in El Dorado, Arkansas without a jury. The two recent FLP district court refund cases, Keller and Murphy, (which were both huge taxpayer victories) have both involved non-jury trials. The excellent trial attorneys in both cases chose to proceed with bench trials and avoid jury trials. (It is also interesting that the Murphy family is from El Dorado, Arkansas, where Murphy Oil Corporation is headquartered and where the trial was held. Query whether there was some "home town" advantage of trying this tax case in the community where decedent and his family were prominently known?)

Another interesting trend is that a number of the recent cases involving FLPs have been district court decisions. This may suggest a trend of taxpayers choosing to avoid the Tax Court regarding FLP matters, particularly for §2036 issues, by paying the deficiency assessed in the audit and filing a Claim for Refund. The obvious downside is that the estate must come up with cash to pay the deficiency, but as evidenced in Murphy, the estate may be able to pick up a significant estate tax deduction for the interest that is paid on loans to secure the cash to make the tax payment.

(6) "Scorecard" of §2036 FLP Cases. Of the various FLP cases that the IRS has chosen to litigate, nine have held that at least most of the transfers to an FLP qualified for the bona fide sale exception — Church (preserve family ranching enterprise, consolidate undivided ranch interests); Stone (partnerships to settle family hostilities); Kimbell ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests); Bongard (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts); Schutt (maintaining buy and hold investment philosophy for family du Pont stock); Mirowski (joint management and keeping a single pool of assets for investment opportunities); Miller (continue investment philosophy and special stock charting methodology); Keller (protect family assets from depletion in divorces); and Murphy (centralized management and prevent dissipation of family "legacy assets"). In every FLP case resulting in taxpayer successes against a §2036 attack the court relied on the bona fide sale exception to §2036.

Interestingly, four of those nine cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the Miller case and authored the Tax Court's opinion in Bongard. Judge Chiechi decided both Stone and Mirowski. (Judge Wherry decided Schutt. Church and

Kimbell were federal district court opinions ultimately resolved by the 5th Circuit. Keller and Murphy are federal district court cases.)

Including the partial inclusion of FLP assets in Miller and Bongard, 19 cases have applied §2036 to FLP or LLC situations: Schauerhamer, Reichardt, Harper, Thompson, Strangi, Abraham, Hillgren, Bongard (as to an LLC but not as to a separate FLP), Bigelow, Edna Korby, Austin Korby, Rosen, Erickson, Gore, Rector, Hurford, Jorgenson, Miller (as to transfers made 13 days before death but not as to prior transfers) and Malkin. In addition, the district court applied §2036 in Kimbell, but the 5th Circuit reversed.

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