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Koons: Interest Deduction and FLP Valuation Practice Pointers

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The Tax Court's *Koons* decision explains the rules for allowing an estate to deduct interest payments, and it details how the court arrived at a determination of the value of a family limited liability company interest.

In *Koons*,[1] the Tax Court denied an interest deduction on a loan made by the decedent's family limited liability company to the decedent's revocable trust, and it determined the value of the trust's interest in that LLC at the decedent's death.

At his death on March 3, 2005, the decedent had four children from his first marriage, seven grandchildren, and two former wives. Following in his father's footsteps, the decedent invested heavily and worked in Burger Brewing Co., ultimately becoming president and CEO. That company became Central Investment Corp. (CIC) and changed its products and activities to Pepsi bottling and distribution and vending machines.

Beginning in the late 1990s, PepsiCo Inc. (Pepsi) and CIC were involved in litigation over CIC's exclusive right to sell Pepsi syrup to various businesses in CIC's geographical area. During 2004, CIC and PepsiAmericas Inc. (PAS), a Pepsi affiliate, agreed that CIC would sell its soda and vending machine enterprise to PAS. Before that sale, CIC transferred its assets not covered by the agreement to its newly formed wholly owned subsidiary, Central Investment LLC (CI LLC). That asset transfer was completed between October 1, 2004, and January 9, 2005.

On December 15, 2004, the parties (PAS, CIC stockholders, CIC, CI LLC, and a short-lived holding company created for the sole purpose of transacting the sale) signed a stock purchase agreement. On that date, the decedent owned 46.9 percent of CIC's voting stock and 51.5 percent of its nonvoting common stock. His children also owned CIC shares. Using the holding company, the stock purchase agreement required all CIC shares to be sold to PAS for $340 million[2] at closing. Although not in the written contract, it was stipulated to the court that Pepsi paid $50 million, which CIC had agreed to contribute to CI LLC, to settle the litigation.[3] The children's sale agreement was subject to CI LLC's agreement to redeem their shares in the LLC. CI LLC's December 21, 2004, redemption offer contained many conditional provisions, including those concerning the determination of price.[4]

The stock purchase agreement closed on January 10, 2005, and two days later the holding company merged and dissolved into CI LLC. CI LLC then owned the PAS sales proceeds, the litigation settlement award, and the non-soda and non-vending machine assets of CIC.[5] CI LLC was, however, under the stock purchase agreement, subject to obligations until January 10, 2012, that required the LLC to "own directly at all times cash, cash equivalents or marketable securities with an aggregate fair market value of at least $10 million" and to keep a minimum net worth of $40 million.

CI LLC's amended operating agreement required that it make distributions to satisfy members' tax liabilities[6] for LLC profits. It also required permission to make discretionary cash distributions to members, to transfer their interests to the decedent's "direct lineal descendants," and, by a minimum 75 percent members' vote, to transfer interests to others.

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[1]*Estate of Koons v. Commissioner*, T.C. Memo. 2013-94.

[2]Under the stock purchase agreement, the $340 million would also include a working capital adjustment so that the actual sale price was approximately $352.4 million.

[3]Unwritten, agreed-on transfers occurred on January 7, 2005.

[4]The four children redeemed their interests in CI LLC separately in 2005 on January 24, January 27, February 22, and February 27.

[5]Among the transferred assets was a health fitness club owned by CIC since 1987.

[6]On February 27, 2006, CI LLC's operating agreement was further amended to cover not only federal and state taxes but also local taxes.

On January 7, 2005, the decedent took out a two-week loan for $30 million and timely repaid it. On the day he repaid that loan, he also lent CI LLC $20 million for three years at 3.5 percent interest (CI LLC repaid the loan in full by September 30, 2005).[7] Also on January 7, CI LLC distributed $100 million pro rata to its members, including approximately $29.6 million to the decedent's children that reduced their redemption payments under their redemption offers from the LLC. Apart from the $100 million distribution, CI LLC paid $90,700,169 in the redemption.

On February 4, 2005, the decedent amended his 1989 revocable trust,[8] after which his children were removed as beneficiaries and replaced by the decedent's ''grandchildren, the lineal descendants of Koons' grandchildren, and the surviving spouses of either group.'' Six days later, the decedent contributed his CI LLC interest to his revocable trust. As of his February 16, 2005, amendments to the trust, if the decedent revoked the trust, its assets reverted to him. The trustees had the right to borrow funds for any purpose. As the decedent directed in writing to the trustees, he would receive the trust's income. He had the right to direct the trustees how to exercise the trust's CI LLC voting powers and how to dispose of its CI LLC interest. After the decedent's death, the trustees were required, as requested, to pay the decedent's executor for estate taxes, expenses, bequests, and obligations other than noncontractual claims. Thereafter, the trust would continue in perpetuity, with the trustees paying discretionary amounts of income and principal to the beneficiaries. No descendant of the decedent could be a replacement trustee.

On February 18, 2005, the decedent in writing directed the trustees to vote his trust's CI LLC interest to amend the LLC's operating agreement to (1) eliminate his children as permitted transferees of membership interests; (2) eliminate the board of advisers (which included the decedent's children); and (3) for the first 15 years of CI LLC's operations, limit discretionary distributions per year to 30 percent of the excess of distributable cash over income tax distributions made under section 3.4 of the operating agreement.[9]

Three days later, the decedent's eldest child, James, wrote to his father,[10] describing the redemption offer as ''punitive'' but thanking him for the ''exit vehicle'' and acknowledging that his siblings would ''like to be gone.'' James envisioned that the LLC's board of managers would buy operating companies[11] instead of passive investments, which he considered more advisable. He also foresaw what he considered inevitable litigation when the board began to make its decisions for the LLC's benefit rather than the family's benefit. A few days before his death, the decedent answered James's letter, saying he would look into his suggestions and would notify him if he decided to adopt any of them.[12]

At Koons's death, the net value of CI LLC was $317,909,786, and its assets included $322,117,296 in cash. After completion of the redemption on April 30, 2005, the decedent's revocable trust owned 70.93 percent of CI LLC and, on February 27, 2006, the estate's assets apart from the revocable trust had a total value of $26,651,426, including liquid assets amounting to $19,192,791.[13]

One year after Koons's death, his nephew sued all CI LLC members on the ground that the decedent had breached his fiduciary duties in 1984 as trustee of the nephew's immediate family trust. The suit was dismissed June 4, 2009, as time barred. On February 22, 2007, the decedent's grandchildren asked the LLC to redeem their present interests at book value, but on April 26, 2007, the LLC declined their request.

The estate claimed an interest deduction for $71,419,497 on the decedent's estate tax return.

[7]On February 25, 2005, the decedent transferred 55 percent of the payments under this loan ''to the trustees of the J.F. Koons III Supplemental Revocable Trust dated 2/16/2005 and 5 percent of the payments to the trustee of the J.F. Koons III Revocable Trust for the benefit of Mary Jane Mitchell and John H. Mitchell dated 2/16/2005.''

[8]On July 20, 2004, the decedent executed his will, which designated his revocable trust as the residuary beneficiary of his estate.

[9]On March 1, 2005, the LLC's operating agreement was amended to limit discretionary distributions with that restriction. Effective June 29 of that year, the agreement was amended to prohibit transfers of LLC interests to the decedent's children.

[10]James e-mailed a copy to his siblings.

[11]In December 2005 CI LLC purchased a wood pallet recycling business for about $2.85 million. In September 2008 the LLC sold most of the assets of that business. In August 2006 the LLC bought CK Products, another operating company, for about $7.3 million, but those were the only two operating companies it had acquired.

[12]At Koons's death, CI LLC employed 40 persons in various positions, as required and paid for by the stock purchase agreement.

[13]The trust owned a 70.42 percent voting interest in the LLC and a 71.07 nonvoting interest. In 2009 the LLC's subsidiaries had a positive cash flow and distributed about $1.3 million to the LLC.

Apart from the CI LLC interests owned by the decedent's revocable trust, the estate possessed about $19 million in liquid assets on February 27, 2006, when the estate tax liability amounted to about $21 million and the trust had a $21 million generation-skipping transfer tax as self-assessed, respectively, on those returns.[14] On February 28, 2006, CI LLC made a $10.75 million loan to the decedent's revocable trust to pay the estate and gift tax liabilities. The loan had an interest rate of 9.5 percent and was repayable in 14 annual payments of about $5.9 million, beginning in 2024 and ending in 2031, with no prepayment allowed. The total interest element was $71,419,497. The trust's main asset was its CI LLC interest, which held more than $200 million in highly liquid assets.[15]

Explaining the requirements of an interest deduction under section 2053, the Tax Court cited the regulation that says administrative expenses must be "necessarily incurred" and "essential to the proper administration of the estate."[16] For interest payments, the loan must be necessary to avoid liquidating assets at less than FMV. Under that criteria and based on its findings, the court denied the interest deduction. The court found that the revocable trust did not need to take out a loan for $10.75 million to pay taxes since it owned more than 70 percent of CI LLC, which had available many times the liquid assets necessary to satisfy the liabilities. It also noted that the trust could force the LLC to distribute its assets.

The court rejected the taxpayers' argument that the loan was better than a cash distribution because the latter would have made it more difficult for the LLC to purchase businesses. The court said that the loan itself removed the same amount of cash from the LLC, that cash distributions were necessary for the trust to repay the loan, and that keeping the estate open for up to 25 years after Koons's death for the loan repayment was contrary to proper administration of the estate.

Next, the court considered the value of the revocable trust's interest in CI LLC at the decedent's death when the LLC had a net value of $317,909,786 and when the trust owned a 50.5 percent interest in the LLC. Multiplying those two figures, the court found the pro rata asset value to equal $160,544,442. The parties disagreed on the proper lack of marketability discount. The taxpayers argued for a 31.7 percent discount, and the government argued for a 7.5 percent discount.[17]

The taxpayers' expert, whose report to the court had figures different from those submitted for the estate tax return, rejected the application of a control premium because the revocable trust's voting interest was only 46.94 percent.[18] Basing his values on his 2001 regression study of 88 companies, the expert assigned values to the equation, resulting in the calculation of a 26.6 percent discount. From that figure, he adjusted for differences between the LLC and the companies in the study. He applied an additional 4 percent discount because of the unique restrictions and liabilities of the LLC and an additional 3 percent discount because (1) CI LLC was a closely held, small, unknown LLC; and (2) a 75 percent vote of the members was required for an interest in CI LLC to be sold to anyone who was not a direct descendant.

The government's expert agreed that no control premium should be applied, although he considered it likely that the redemptions would take place. That was because he also thought that with the main LLC assets consisting of cash as opposed to a business, it was unlikely a controlling LLC interest would sell for more than its proportional net asset value. The expert, however, said he believed that a small discount of between 5 and 10 percent should be applied because (1) there was little risk that the redemption would not occur; (2) the LLC had obligations under the stock purchase agreement; (3) the LLC was likely to make cash distributions; (4) the LLC had transfer restrictions; (5) the trust was able to force distributions from the LLC after the redemptions; and (6) and the LLC's assets were predominantly liquid.

The court determined that the major difference between the two marketability discount figures was each expert's assumption of the likelihood of the redemption of the children's interests in CI LLC. Because the court considered it highly probable that the redemptions would indeed occur, it agreed with the government's valuation expert. At Koons's death, the redemption offers had been agreed to by the children and constituted binding contracts. The price could easily be determined because most of

[14]Those figures were raised in their notices of deficiency to $64 million and $20 million, respectively.

[15]Its two operating companies constituted only 4 percent of the LLC's holdings.

[16]Reg. section 20.2053-3(a).

[17]Applying those discounts, the parties contended that the values were, respectively, $109,651,854 and $148,503,609.

[18]Likewise, he said that even a 70.4 percent voting interest after the redemption of the children's interests could not receive private benefits because of the limitations on asset distributions and supermajority vote requirements for some decisions under the LLC's operating agreement and the stock purchase agreement's restrictions on dissolution and full asset distributions until after January 10, 2012.

the LLC's assets were cash. The court observed that under those circumstances, a state court would have enforced the signed offer letters. Moreover, because it was essential that the children no longer own an interest in the LLC, a court would have ordered specific performance. Although the taxpayers contended that the children would not ultimately go through with the sale, the court held that the facts indicated the opposite: Both sides wanted to effectuate the redemption agreement.

The court also agreed with the rest of the analysis of the government's expert. It found that the interest should be considered a majority interest, without a lack of control discount. The court accepted the expert's assumption that an LLC member with a 70.42 percent interest could by himself force the company to sell most of its assets since the stock purchase agreement only provided for the LLC to retain $10 million in liquid assets and keep a minimum net worth of $40 million until January 10, 2012. Regardless of the decedent's expressed request that the LLC purchase operating businesses after he died, hypothetical parties to a sale of the trust's interest in the LLC would know that the interest carried with it the opportunity for a forced sale of approximately $140 million in LLC assets. Thus, the court considered $140 million the minimum value of that interest.

The court dismissed criticisms of the report prepared by the government's expert, saying that it suitably accounted for the stock purchase agreement restrictions and the potential for a lawsuit. The lawsuit, the court said, concerned the decedent's actions approximately 20 years earlier, was brought a year after the decedent's death, and was ultimately dismissed as time barred. Moreover, the court said that despite assertions to the contrary, the government's expert considered the transferability restrictions but did so within the context of the majority interest's power over an extremely liquid company. Thus, despite not applying a regression analysis, the court found that the opinion of the government's expert was based on experience and common sense. Moreover, the regression equation formulated by the taxpayer's expert was rooted in data derived primarily from active businesses with minority ownership interests, whereas the LLC possessed only two small businesses and mostly cash, and the trust's interest was effectively a majority interest. Finally, the regression equation overestimated and incorrectly assigned valuation discounts by tying them to the size of the block of stock instead of the regulatory restraints.

Therefore, the court adopted the government's figure of $148,503,609 as the date-of-death value of the revocable trust's interest in CI LLC.

Black

The decedent in *Black*,[19] a former Erie Indemnity Co. employee, became the company's second largest shareholder. The decedent and his wife had one son and two adult grandsons. The son had marital problems, and his Erie stock, as his principal asset, would be at risk in a divorce. The decedent's grandsons were unemployed and financially naïve. The decedent had created trusts for them, funded with Erie stock, and the son served as trustee. But the trust's term was ending. The decedent created a family limited partnership to keep the trust from selling the stock, which represented 13 to 14 percent of the total Erie stock. He did that so the stock could retain its power as the swing vote between the two major factions of stockholders and for estate planning purposes. At that time, the decedent and his wife held more than $4 million outside the FLP and had sufficient income, ranging from around $303,000 to $2.2 million annually, to cover their expenses.

The FLP retained the Erie stock, along with some real estate and shares in the decedent's own insurance company, until after the decedent's death in 2001, at which time the FLP's net asset value was more than $315 million. At the decedent's death, his estate had enough cash assets to pay the estate tax liability of about $1.7 million. However, his widow died soon after him, and her assets were insufficient to pay her administrative expenses and her estate taxes.

Unsuccessful in borrowing elsewhere, the decedent's son, as executor of his mother's estate, contracted with the FLP to lend the estate $71 million, with interest and principal payable in full not before November 30, 2007. Her estate took a section 2053 deduction of $20,296,274 in interest payments.

The Tax Court granted judgment in favor of the estate on the section 2036 issue and held that the decedent's transfer of his Erie stock to the FLP fell within the exception for a bona fide sale for adequate and full consideration. However, the court held that the FLP loan to the wife's estate and to the decedent's revocable trust was unnecessary:

> The only distinction between the loan scenario and the partial redemption scenario is that the former gave rise to an immediate estate tax deduction for interest in excess of $20 million. . . . That the loan scenario, like the partial redemption scenario, required a sale of Erie stock to discharge the debts of Mrs. Black's estate, i.e., that Erie stock was available and

[19] *Estate of Black v. Commissioner*, 133 T.C. 340 (2009).

> actually used for that purpose, negates petitioner's contention that the loan was needed to solve a "liquidity dilemma."[20]

Thus, while allowing deductions relating to a secondary offering of the FLP's Erie stock, the court held that the wife's estate could not deduct the interest on the loan.

Analysis and Conclusion

As in *Black*, in which the estate had access to sufficient liquid assets to pay the estate tax liability, the court in *Koons* refused to allow the estate to deduct interest on an unnecessary loan. In both cases, but especially in *Koons*, the identities of the lender and borrower, the estate's access to liquid or readily liquid assets, the length of the loan, and the prohibition against prepayment all clearly indicated that the reason for the loan was primarily to achieve an estate tax deduction and not to assist in the timely administration of the estate.

On the issue of the proper marketability discount in *Koons* as between the taxpayers' figure of a 31.7 percent discount and the government's assertion of a 7.5 percent discount, the court sustained the government's relatively small discount on the basis that the facts indicated that the children's redemption was essentially complete at the decedent's death. That conclusion led the court effectively to ascribe to the decedent's revocable trust a 70.42 percent voting interest in CI LLC. As the court said, that majority interest would be sufficient to force the LLC to sell most of its liquid assets, especially since the stock purchase agreement required only a relatively small retention of assets through January 10, 2012. Having made that finding and critical of the taxpayers' expert's reliance on a study involving companies holding operating businesses unlike the passive CI LLC assets, the court reasonably adopted the government's 7.5 percent lack of marketability discount.

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[20]*Id.* at 384-385.