VALUATION DISCOUNTING:

FAMILY LIMITED PARTNERSHIPS AND OTHER FRACTIONAL INTEREST PLANNING

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Valuation Discounting:

Family Limited Partnerships and Other Fractional Interest Planning

Frederick R. Franke, Jr.

"…The use of FLPs and similar devices is eroding the transfer tax base. Taxpayers take the position that they can make value disappear by making contributions of marketable assets to an entity, and then making gifts of interests in such entity to family members. This disappearing value is illusory, because family members are not minority interest holders in any meaningful sense. Moreover, it is implausible that the donor would intentionally take an action (contribution of the property to an entity) if the donor really believed that such action would cause the family's wealth to decline substantially. The proposal would eliminate valuation discounts except as they apply to active businesses. Interests in entities would be required to be valued for transfer tax purposes at a proportional share of the asset value of the entity to the extent that the entity holds readily marketable assets (including cash, cash equivalents, foreign currency, publicly traded securities, real property, annuities, royalty-producing assets, non-income producing property such as art or collectibles, commodities, options and swaps) at the time of the gift or death. To the extent the entity conducts an active business, the reasonable working capital needs of the business would be treated as part of the active business, i.e., not subject to the limits on valuation discounts. No inference is intended as to the propriety of these discounts under current law. This proposal would be effective for transfers made after the date of enactment." *General Explanations of the Clinton Administration's Revenue Proposals for FY 1999.*

I. Basic Valuation Concepts.

A. For federal estate tax purposes, I.R.C. § 2031 "defines" the gross estate as the "value" of all of a decedent's property.

1. The Regulations set forth the "classic" description of fair market value as the determining factor: "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

2. A parallel provision is contained in the gift tax provisions. Reg. § 25.2512-1.

3. These determinations of value are essentially factual determinations.

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B. Revenue Ruling 59-60.

1. General approach: "A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases." Factors to consider when analyzing value include:

“a. The nature of the business and the history of the enterprise from its inception.

b. The economic outlook in general and the condition and outlook of the specific industry in particular.

c. The book value of the stock and the financial conditions of the business.

d. The earning capacity of the company.

e. The dividend-paying capacity.

f. Whether or not the enterprise has goodwill or other intangible value.

g. Sales of the stock and the size of the block of stock to be valued.

h. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter." Rev. Rul. 59-60.

2. "The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock." Id.

3. Revenue Ruling 59-60 continues (with amplification) as the fundamental pronouncement of value from the Internal Revenue Service. See: Rev. Rul. 83-120; Rev. Rul. 80-213; Rev. Rul. 77-287; Rev. Rul. 65-193.

C. The Discount for Lack of Marketability.

"The lack of marketability discount applies to bridge the valuation gap between investment assets that are readily saleable in an active market and those which offer

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no such liquidity opportunity to the hypothetical purchaser. The absence of a market means that the purchaser cannot assume the availability of a buyer when his time comes to sell, with the result that the purchaser will probably experience trouble in disposing of the property, and, moreover, the selling price will often be hard to establish. The outcome may well be the acceptance of a lower price to attract a buyer. Almost 30 years ago the courts began to recognize this compensating discount over the objections of the Service. Wallace, "Now You See It, Now You Don't -- Valuation Conundrums in Estate Planning," 24 Inst. Est. Plan. ¶ 803.2, 8-9 (Miami 1990).

1. "Registered stock and partnership interests sold in a public market can generally be sold immediately and for cash. Even without legal or contractual restrictions on an ownership interest, and even if the seller has voting control, the owner of a privately held company must wait until he or she can locate a willing and qualified buyer with whom he or she can negotiate and close the sale. Even then, the seller may be required to finance a part of the acquisition price to make the sale possible. His or her interest in the closely held company is not liquid, and he or she must discount the present value of his ownership interest to account for the time value of money. This discount is generally called a discount for lack of marketability. For a controlling interest, the market discount considers the time cost of money, the present value of the investment discounted by the cost of investment capital as determined by the investment risk." Gibbs, "Do You Speak Tax, Mr. Appraiser? Evaluating the Appraiser and the Appraisal Report After 1990," 27 Inst. Est. Plan ¶ 1502.5, 15-16, 15-16 (Miami 1993).

2. "In the past three or four years, the liquidity of the U.S. economy as a whole has vastly improved, and this new factor is reflected in almost all types of financial markets. It would be very much to be expected, therefore, in valuing closely held securities, that a tendency toward greater discounts in these times would be observed, especially if that discount were occasioned by a perceived lack of today's quite common liquidity. *Wallace*, supra. at ¶ 803.3, 8-13 (quoting from Moore, "Valuation Revisited," 126 Tr. & Est. 40, 43 (Feb 1987).

D. The Minority Interest Discount.

"A separate and distinct discount applies to reflect the fact that a shareholder who owns less than a majority interest cannot control current or long-range managerial decisions, impact the future earnings or growth potential of the enterprise, establish executive compensation, and the like. More significantly, the minority interest discount compensates for the inability of a minority owner to obtain a representative share of the underlying assets in the company, which often represent a premium value compared with the ongoing current yield produced by those assets. This latter valuation discrepancy is often exacerbated when the minority interest is in a holding company owning valuable properties invested for long-term growth, or operating

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businesses, such as a ranch or a timber company, which historically produce a relatively low level of earnings in comparison with the values of their underlying assets." Wallace, at ¶ 803.4, 8-14, 8-15.

E. Discounts for Built-in-Gains.

1. Taxpayer victories have reversed long-standing Internal Revenue Service policy not to give discounts due to built-in gain problems. Since repeal of the General Utilities Doctrine, this is a serious issue. The pro-Taxpayer cases are: *Est. of Davis*, 110 T.C. 552 (1993) and *Eisenberg v. Commissioner*, 155 F.3d 50 (2nd Cir. 1998).

2. *Estate of Jameson v. Comm.*, 267 F.3d 366 (5th Cir. 2001) discussed the issues involved in calculating the extent of the capital gains discount. The Internal Revenue Service argued that the purchaser would not sell off timber but would hold the property whereas the taxpayer argued that the hypothetical buyer would sell off timber creating immediate gain. The speed of sell-off would determine the present interest of the discount. The case was remanded for the factual determination.

3. In *Jones v. Comm.*, 116 T.C. 121 (3/6/01), the Tax Court rejected a built-in gains discount for a family limited partnership based on the assumption that a limited partner could effectively get a §754 adjustment. See discussion below.

F. Discounts for IRD Status.

1. TAM 200247001 held that there should be no discount on an IRA to reflect income tax "taint" carried by § 691 property. The ruling recited that § 691 provides a statutory remedy to the double tax potential via the estate tax deduction.

2. Also see TAM 200303010 which rejected any discount for Series E US Saving Bonds.

G. "Tax-Effecting."

1. Tax-effecting is an adjustment that is made to valuations based on a discounted cash-flow approach. An S Corporation pays no income tax at the corporate level. When a discounted cash-flow analysis is being made to an S Corporation, the issue is whether to normalize free cash/flow by subtracting a hypothetical income tax to make the calculation comparable to C Corporations. "[A]ppraisers disagree on whether it is appropriate to tax-effect the income of an S Corporation. The argument in tax-effecting stresses that many potential buyers of S Corporations are C Corporations. Because a C Corporation would be unable to maintain a target company's S Corporation

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status following an acquisition, the C Corporation would tax-effect the S Corporation's income (at C Corporation rates) in deciding how much it would pay for the S Corporation…by contrast, the argument against tax-effecting stresses that although an S Corporation's stockholders are subject to tax on the corporation's income, they are generally not subject to a second level of tax when that income is distributed to them. This would make an S Corporation at least somewhat more valuable than an equivalent C Corporation. However, tax-effecting an S Corporation's income, and then determining the value of that income by reference to the rates of return on taxable investments, means that an appraisal will give no value to S Corporation status." *John E Wall*, 81 T.C.M. 1425 (2001) at footnote 19.

2. In *Walter L. Gross, Jr.*, 78 T.C.M. 201 (1999) the Tax Court rejected the opinion of the taxpayers' expert that projected earnings should be tax-effected. A divided 6th Circuit affirmed the Tax Court ___ F.3d ____ 2001, WL 1456356 (6th Circ. 11/19/01). In the Court of Appeals, the Court held that the Tax Court did not abuse its discretion in allowing the Internal Revenue Service appraiser to testify as to value without making an adjustment for tax-effecting. The Court, in part, based this conclusion on the fact that it was factually determined that it was not established that there was any likelihood that the S election would be lost. Indeed, in the *Gross* case the shareholders had signed an agreement to maintain the S election.

3. *Gross* involved the gift of a small minority of shares in the S Corporation. See also *Adams*, T.C. Memo 2002-80 likewise rejecting tax-effecting.

H. Ownership Within the Family.

1. Generally, there is no family attribution when determining "control" for gift or estate tax purposes.

a. Rev. Rul. 93-12: "If a donor transfers shares in a corporation to each of the donor's children, the factor of corporate control in the family is not considered in valuing each transferred interest for purposes of section 2512 of the Code. For estate and gift tax valuation purposes, the service will follow Bright, Propstra, Andrews, and Lee in not assuming that all voting power held by family members may be aggregated for purposes of determining whether the transferred shares should be valued as part of a controlling interest. Consequently, a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest. This would be the case whether the donor held 100 percent or some lesser percentage of the stock immediately before the gift."

(1) PLR 9449001: "If all the shares of stock in a closely-held

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corporation are given simultaneously to 11 family members, the value of the gift to each donee is determined by considering each gift separately and not by aggregating all of the donor's holdings in the corporation immediately prior to the gift. The application of any discounts for lack of control or marketability would be determined in connection with each separate gift to each donee."

(2) PLR 9403005 was illustrative of a trap the discounting can create. In that ruling the block of stock in the gross estate was not a minority interest and thus did not qualify for a minority interest discount. Part (not all) of the stock was specifically bequeathed to the marital trust. This portion qualified for a marital deduction -- but at a value "enjoying" the minority discount.

2. In TAM 9436005, the Internal Revenue Service took the position that a gift of a minority interest in the family business should be adjusted upward when the gift represents the "swing vote" when all shareholders are relegated to minority status by virtue of the gift.

   a. In determining the value of three 30% blocks of stock, each block must be adjusted upward to reflect the "swing vote attributes" of each block. This seems to be at odds with viewing each gift as a separate occurrence.

3. Chapter 14 imposes family attribution concepts in respect to transfers of junior equity if senior equity retained. See IRC § 2701. Family control of entity is also required for application of §§ 2703 and 2704.

4. In *Mellinger v. Commissioner*, 112 T.C. No. 4 (1/1/99), acq. 1999-35 IRB, 314 (8/l999) (result only); also Action on Decision 1999-006 (full acquiescence), it was held that stock held in a QTIP trust would not be combined with the stock held by the surviving spouse to determine whether a control premium should be applied. The Court held that IRC § 2044 requires the value to be included in the survivor's gross estate but that interest is not aggregated with holdings by the estate. In *Mellinger* the surviving spouse was not a trustee of the QTIP and therefore could not vote the shares. If this is an important element restrictions on the surviving spouse's power to vote the QTIP shares may be prudent. In AOD 1999-006, no mention of this fact was referenced. *Mellinger* followed a similar result in *Bonner v. U.S.*, 84 F.3d 196, 198 (5th Cir.) for community property jurisdiction.

5. In *Est. of Fontana*, 118 T.C. No. 16 (3/28/02) the Tax Court refused to extend the *Mellinger* treatment to general power of appointment trusts. Thus, stock held by the surviving spouse and the general power of appointment trust was

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aggregated for valuation purposes.

I. Substance-Over-Form Attacks.

1. In *Murphy v. Comm'r*, 60 T.C.M. (CCH) 645 (1986), a transfer 18 days before death of a small amount of stock (1.76%) to "convert" the decedent's holding to a minority position (49.65% after the transfer) was ignored. The Court found that the sole purpose of the gift was to impact the federal estate tax. [The transfer did "not appreciably affect decedent's beneficiary interest except to reduce Federal transfer taxes." At 661.] Obviously non-tax motivating factors need to exist. *Murphy* did not involve a change in the legal form of the asset which would involve very real state law rights. Instead it only involved a transfer of a small holding of existing stock.

    a. *Murphy* is used by the IRS in attacking the creation of family limited partnerships. In *Knight v. Comm'r*, 11 T.C. 506 (11/30/00) (see below), the majority opinion rejected the substance over form attack including *Murphy*: "our holding is in accord with these cases because we believe the form of the transaction here (the creation of the partnership) would be taken into account by a willing buyer; thus, substance and form of the transaction are not at odd for gift tax valuation purposes." In *Strangi v. Commissioner*, 115 T.C. 478 (11/30/00) (see below) Judge Beghe in his dissenting opinion stated that he would apply the *Murphy* principle to *Strangi*.

2. The treatment in *Murphy* should be contrasted to the treatment of *Estate of Frank*, T.C. Memo 1995 – 132 (3/28/95). In *Frank*, Mr. Frank held a controlling interest in a corporation which, in turn, owned and operated various motels located on the New Jersey shore. The other stock was held by his wife and children. Two days before his death, his son transferred corporate stock under a durable power of attorney from the father to the mother. The mother died approximately two weeks after the father. One result of the transfer of the substantial block of stock from the father to the mother was to reduce the father's ownership from 50.2% to 32.1%. The memo opinion held: "As a general rule, we will respect the form of a transaction. We will not apply substance over form principles unless the circumstances so warrant." The Court held that "if tax avoidance was the sole motive, a substantially smaller number of shares could have transferred. We find it unnecessary to decide this dispute over the motive for the transfer."

J. The Importance of the Appraisal.

1. Obviously, the valuation report is key to negotiating through an audit, or winning in Court. Indeed, the best insurance against being in Court is having a solid valuation report that could be used in Court. Judge David Laro, of the

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U.S. Tax Court gave his recommendations for presenting an expert before the Tax Court on a valuation issues (from a speech given by Judge Laro 1/18/01 before the 2001 Advanced Estate Planning Institute of San Francisco, California):

> "Court-appointed experts are not necessary simply because the various experts and appraisers chosen by the parties disagree. Acquiring some awareness of what courts look for and experts may be of some value to you. Accordingly, let me suggest the following:
>
> (1) First, always read the opinions on valuations on opinions that were written by the judge handling the case. This should give you a feel for the type of valuation methods that the judge prefers.
> (2) Read and understand the recent opinions of the Court written by other judges on a related topic. You may find a valuation situation addressed which is very similar to yours and which can provide guidance.
> (3) Make known clearly the qualifications of the expert. Recent cases indicate that an expert's credentials and experience continue to be factors that a court will take into account.
> (4) Make special efforts to make sure that the expert's data is highly relevant and empirical in nature.
> (5) Prepare a very cogent and credible valuation report. Expert witnesses in the Tax Court are essentially limited in their testimony to the contents of the report."

2. The appraisal submitted with the 706 is difficult for an estate to later repudiate. See _Estate of Leichter_, 92 T.C. 312 (2003) where demonstrating that appraiser misstated date of death, failed to take into account liabilities, admitted improper methodology, etc. was not enough for the taxpayer to rebute the position taken on the 706. Those preparing the 706 need to focus on mistakes in factual assumptions before the position on the 706 is finalized.

II. Legislative Initiatives to Erode Discount Planning: An Overview of Chapter 14 Issues.[1]

A. Chapter 14. The Revenue Reconciliation Act of 1990 enacted Chapter 14 to the Code (comprised of §§ 2701 -- 2704) for transfers generally after 10/8/90. These new rules cover certain situations where an intra-family transfer occurs and the transferor (or certain other family members) retain certain other interests in the property (an "applicable retained interest"). Generally, Chapter 14 addresses the value of the gift.

1. Section 2701 generally attacks corporate and partnership recapitalizations

[1] This section of the outline began as a collaborative effort by Frederick R. Franke, Jr. and Paul E. Burke, Jr. that evolved over time. Paul was an estate planning lawyer with a practice in Baltimore who died November 21, 1999 from complications after surgery. He was recognized as, and he was, a fine estate and trust lawyer.

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designed to freeze the senior interest. Mechanically, the provision forces the "subtraction method" of valuation for gift purposes and dictates that certain discretionary rights are to be ignored for the purpose of calculating the interest.

a. Under usual valuation methodology, an appraiser would assume that the senior owner's rights would be exercised in order to maximize its value. In the family setting, § 2701 assumes that the rights would not be exercised.

(1) In Snyder v. Commissioner, 93 T.C. No. 43 (1989) (cited by the Senate Committee Report), a grandmother transferred her portfolio into a holding company and kept a call at her election for the full value of the portfolio at inception less $1,000. The grandchildren received common stock in the holding company subject, of course, to the call of the preferred in the grandmother's hands. The gift to the grandchildren was valued at $1,000. Section 2701 would reverse this result.

(2) "The theory underlying § 2701 is that an interest in a corporation or partnership is valued by reference to the bundle of rights that make up the interest, and that non-mandatory rights (such as the right to non-cumulative dividends or to put stock back to a corporation at a set price) held by the transferor or applicable family members are likely to be exercised to maximize the value of the donee/family-member's interest. For example, a transferor of common stock who retains non-cumulative preferred is not expected to pursue the right to receive the dividend payment, in effect increasing the value of the transferred common. In line with this theory, § 2701 provides generally that in valuing retained interests that carry discretionary rights (i.e., applicable retained interests), such rights would be valued at zero. Thus, the gift probably is greater than what it would be under normal valuation rules." Schneider & Plaine, "Proposed Valuation Regulations Flesh Out Operation of the Subtraction Method," 75 J. Tax. 82-83 (August 1991).

b. The provisions of §2701 do not, however, preclude estate freezes. See: Zaritsky and Aulcott, "Structuring Estate Freezes under Chapter 14"; Paul E. Burke, Jr.: "Partnership Freeze" (MICPEL Family Partnerships, 1996): "Using Partnerships for Family Estate Holdings" (MICPEL, 1987 Estate Planning for Real Estate): "Using Estate Freezing Techniques for Family Business Planning" (MICPEL 1997 Succession Planning).

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(1) The Internal Revenue Service applied § 2701 to the formation of an investment partnership where the children contributed 1% of the asset value to a limited partnership in exchange for a 35% general partnership interest. The senior generation contributed 98% of the value for a 65% limited partnership interest, yet received all distributions, until the capital account balances of the limited partners became zero. The senior generation was seen as retaining control of the general partnership interest due to operation of § 2071 (b)(2)(B) and § 2701 generally applied for valuation purposes. PLR 199933022 (8/1999).

2. Section 2702 addresses trust and/or term interests.

a. Under prior law, a subtraction method was generally applied: the amount of a taxable gift from a transfer in trust has been the value of the property contributed to the trust, less the interest retained by the transferor. Section 2702 provides special rules for valuing the retained interest. Additionally, this provision treats certain non-trust term interests and joint purchase arrangements as if held in trust.

(1) As with the scheme of § 2701, under § 2702 the retained rights are deemed to be valued at zero, thus increasing dramatically the value of the gift. Thus, for example, in a grantor retained interest trust (GRIT) where the transferor retains the income for ten years, the gift of the remainder is carried at full market value.

b. Section 2702, however, does not apply if the retained interest is a qualified interest:

> "A 'qualified interest' is the right to receive a fixed amount payable at least annually (that is, an annuity interest), an amount payable at least annually equal to a fixed percentage of the fair market value of the trust property determined annually (that is, a unitrust interest), or a non-contingent remainder following one of the above. These rules are intentionally patterned after the rules applicable to charitable split-interest trusts contained in § 664…In other words, a grantor's retained income interest for a term for years in most assets--as in a traditional grantor retained income trust (GRIT) -- will be given a value of zero. On the other hand, a retained interest in the form of a qualified annuity or unitrust amount -- a grantor retained annuity trust (GRAT) or grantor retained unitrust (GRUT) -- will be determined in the customary way." Zaritsky & Aucutt, Structuring Estate Freezes Under Chapter

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14, ¶ 3.03[1][a] at 3-4 (Warren Gorham Lamont 1993).

(1) An addition important exception to § 2702 treatment is the qualified personal residence trust (QPRT). The budget proposals for fiscal year 2000 would have eliminated this exemption and made the remainder interest (the subject of this gift) equal to the fair market value of the property.

3. Section 2703 deals with restrictions on transfers (buy-sell agreements) in the family context.

a. Section 2703 "codified" the holding of *St. Louis County Bank v. U.S.*, 674 F.2d 1207 (8th Cir. 1982). In that case, the Appeals Court reversed the lower holding that a buy-sell agreement price dictated the value of the decedent's stock shares in a closely held family business. The Appeals Court decision held that the existence of a bona fide business purpose (to assure continued ownership in a family) does not necessarily establish that the instrument is not a "device" to improperly avoid taxes. Also see, *True Est. v. Comm.* T.C. Memo 2001-167 (7/6/01) where the Tax Court ignored buy-sell agreements as "devices."

(1) Section 2703(b) imposes 3 requirements that must be independently met for a buy-sell or other option to be upheld as setting value:

(a) That it is a bona fide business arrangement.

(b) That "it is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth."

(c) Its terms are comparable with similar arrangements entered into by persons in arms length transactions.

b. Internal Revenue Service has attacked some FLP arrangements as a "device" to transfer to the children for less than full and adequate consideration in money or money's worth the "property" contributed by a parent to the FLP. Under this theory, the Internal Revenue Service seeks to ignore the formation of the Partnership under 2703(a) and the safe harbor under 2703(b) on the theory that the Partnership itself was a "device". A series of PLRs have been issued based on the most extreme factual presentations and arguing two alternative positions relative to § 2703, namely:

(1) The formation of the partnership and the transfer of

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partnership interests constitute a single testamentary transaction, and the partnership is disregarded for estate valuation purposes; and

(2) Property for purposes of 2703(a)(2) is the underlying asset of the partnership – not the interest in the partnership.

(3) Internal Revenue Service's attempted expansion of IRC § 2703 has been severely criticized by practitioners and academics. The critics of the Internal Revenue Service's attempted 2703 expansion point out:

(a) Internal Revenue Service cannot ignore the Partnership entity because Internal Revenue Service § 7701(a) requires recognition and treatment as a Partnership for <u>all</u> federal tax purposes.

(b) The "property" transferred is the interest in the Partnership, not the assets contributed to the Partnership. This argument is bolstered if the Partnership is formed by husband and wife and subsequent Partnership interests are transferred to children.

(c) The Internal Revenue Service's theory ignores legislative intent. Section 2703 does not ignore the entity, but only disregards certain options, etc. A fair reading of 2703 and the legislative history indicates that its scope is limited to buy-sell agreements and options.

(d) A large body of statutory, regulatory and case law has consistently recognized the partnership entity, the state law property rights in respect to partnership interests and the fact that a partner has no property right or ownership in specific property of the partnership. The Internal Revenue Service cannot ignore this long-standing body of law.

(e) The § 2703(b) safe harbor cannot be ignored by Internal Revenue Service. Even if a partnership should fail the "safe harbor" of 2703(b), the statute ignores only the right or restriction -- not the Partnership entity.

(f) The Internal Revenue Service's attempted expansion of

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2703 would cause 2704 and to some extent 2701 to be unnecessary and irrelevant.

c. The Service's 2703 expansion efforts were litigated in Estate of White v. Comm., U.S.T.C. Docket No. 14412-97. In this case, Internal Revenue Service has conceded the 2703 issue but the taxpayer requested the Court to rule on that question despite its victory. A ruling would have permitted similarly situated taxpayers to have the Internal Revenue Service administratively estopped from using this argument in other case per Mary Carter Paint Co. v. FTC, 333 F.2d 654 (1964), rev'd on other grounds, 382 U.S. 46 (1965). The Tax Court denied the taxpayer's request. See (S. Stacy Eastland and John W. Porter), "Defending the Family Limited Partnership" - Estate of White v. Comm., 23 ACTEC Notes 278 (1998).

d. Meanwhile, in Church v. U. S., 268 F.3d 1063 (W.D. TEX. 2000) 2000-1 USTC ¶ 60, 369, aff'd per curium, unpublished op. (5th Cir. 7/18/01), the Taxpayer won on all of the Internal Revenue Service's points of attack – including its § 2703 arguments.

(1) Although the partnership was formed two days before Mrs. Church's death, the Court held that her death was unexpected. The Taxpayer put forward facts showing that the transaction was not in "contemplation of death" reminiscent of the old three year rebuttable presumption regarding gifts within three years of death. Here facts were developed to show that Mrs. Church had purchased clothing shortly before her death which was deemed not to be an act of one on her deathbed. Howard Zaritsky gives the Church case the "Do Not Try This at Home" Award for 2001. 27 Tax Management Journal (Estates, Gifts & Trusts) 9 (1/10/02).

(2) The Court found that there was no statutory basis for the Internal Revenue Service's contention that the term "property" as used in § 2703 referred to the assets that Mrs. Church contributed to the partnership rather than to her partnership interest. The Court found no case that would permit it to expand § 2703 to make the partnership as seen as a "device" to restrict the transfer of the underlying property.

(3) Additionally, the Court held that the formation of the partnership was not a sham. Indeed, the Court found that the business purpose of the partnership was to reorganize the running of the ranch so as to remove it from the control of any one fractional interest owner who could use the property at will, interfere with its operations and ultimately force a

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partition sale of the property. The formation of the partnership changed the character of the interest owned by the partners from that of undivided interest holders.

(4) The Court also rejected the Internal Revenue Service's gift on formation argument. The Court analyzed the various cases cited by the Internal Revenue Service (Dickman and Kincaid) and concluded that all of the cases involved an attempt to donatively pass property to others through the formation of business entities in which the donor did not receive an interest proportionate to his or her capital contribution. Because the formation of the partnership did not involve the change in the proportionate interest that Mrs. Church held in the venture, there was no gift on formation. The Court explicitly held that "A taxable gift must involve a gratuitous transfer, which by definition requires a donee." It should be noted that at least one commentator has criticized this holding: "Two elements are wrong in this statement: neither a gratuitous transfer nor or a donee are required by the gift tax. Treas. Reg. Sec. 25.2511-2(a) explicitly states that: 'Identity of a donee is irrelevant – it is the mere existence of a transfer for less than full and adequate consideration that constitutes a gift.' And gratuitous intent is not relevant to application of the tax law, indeed, the law is just the opposite. To avoid gift tax treatment, a Taxpayer must establish that a transfer qualifies under the Treas. Reg. Sec. 25.2512-8 business transaction exception, meaning that although it was made for less than full and adequate consideration in money or money's worth, the transfer was 'made in the ordinary course of business (a transaction which is bona fide, at arms length, and free from any donative intent.' The Duberstein income tax definition that a gift is a transfer flowing from a detached and disinterested generosity is not – in any sense – a gift tax definition, and it confuses the issue to speak in terms of 'gratuitous' transfers for gift tax purposes." Pennell, "Recent Wealth Transfer Tax Developments," MICPEL, May 2000 at 009.

(5) See *Strangi v. Comm.*, 115 T.C. 478 (11/30/00), discussed below, which rejected the § 2703(a) attack. In *Strangi*, the majority held that § 2703 was not intended to have partnership assets treated as if those assets were owned by the estate. See also, *Kerr v. Comm'r.*, 113 T.C. 449 (1999).

4. Section 2704 deals with lapsing liquidation and/or voting rights in a corporation or partnership. This is the "anti-Harrison" provision.

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B. Valuation Discounting under § 2704.

1. Section 2704(a) treats the lapse of the liquidation and/or voting right as a transfer subject to the gift or estate tax in the family context.

   a. The individual holding the lapsed right and the members of that person's family must control the entity immediately after the lapse.

   b. Section 2704(a) would deny a discount based on an inability to dissolve the entity and retrieve full value if a liquidation right would terminate at the death of the general partner.

      (1) Reg. § 25.2704-1(f): "EXAMPLE 5. D and D's two children, A and B, are partners in Partnership X. Each has a 3-1/3 percent general partnership interest and a 30 percent limited partnership interest. Under State law, a general partner has the right to participate in partnership management. The partnership agreement provides that when a general partner withdraws or dies, X must redeem the general partnership interest for its liquidation value. Also, under the agreement any general partner can liquidate the partnership. A limited partner cannot liquidate the partnership and a limited partner's capital interest will be returned only when the partnership is liquidated. A deceased limited partner's interest continues as a limited partnership interest. D dies, leaving his limited partnership interest to D's spouse. Because of a general partner's right to dissolve the partnership, a limited partnership interest has a greater fair market value when held in conjunction with a general partnership interest than when held alone. Section 2704(a) applies to the lapse of D's liquidation right because after the lapse, members of D's family could liquidate D's limited partnership interest. D's gross estate includes an amount equal to the excess of the value of all D's interests in X immediately before D's death (determined immediately after D's death but as though the liquidation right had not lapsed and would not lapse) over the fair market value of all D's interests in X immediately after D's death."

      (2) If, however, D could not unilaterally compel liquidation, then § 2704(a) would not apply. If the entity has more than one general partner and the other partner can elect to continue the partnership, § 2704(a) would not apply. Example 5 is the *Harrison* example as understood by the Internal Revenue Service.

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c. Lapse under 2704(a). Potential exposure under 2704(a) can arise if both preferred (i.e. senior) interest and subordinate partnership interests are retained. Mere differences in voting rights do not cause an interest to be "subordinate."

(1) 2704(a) was specifically directed at the result in *Harrison v. Commissioner*, 52 T.C.M. 1306 (1987). Sec. 2704(a) treats a lapse of any voting or liquidation right in a corporation or partnership as a "transfer" by gift, or transfer includible in the gross estate of a decedent, if the individual holding such "lapsed" right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the entity. 2704(a)(1). Ironically, the draftsman of 2704(a) apparently misread the *Harrison* decision. It did not involve a lapse. In *Harrison* the general partnership units were sold pursuant to the partnership agreement at a price which Internal Revenue Service stipulated was the fair market value of such general partnership interest. S. Stacy Eastland (who prepared the Harrison Partnership Agreement and wrote the taxpayer's brief in *Harrison*) commented that *Harrison* did not involve a lapse, but rather a transfer by sale at full fair market value of the general partnership interest which transferred the voting and liquidation powers inherent in such general partnership interest. Eastland opines that 2703, not 2704(a), would be more applicable to the facts of the *Harrison* case.

(2) After 2704(a) was adopted, Internal Revenue Service apparently realized that it had missed the *Harrison* case by basing 2704(a) on the "lapse" of any voting or liquidation right. Internal Revenue Service now seeks to expand what should be the plain meaning of the word "lapse" to apply to a non-lapsing transfer of voting or liquidation rights in certain circumstances. Examining the changes and arguments relating to the proposed regulations and final regulations defining "lapse" under 2704(a) is instructive. See "Dropping Below Control, Good Planning or Tax Abuse?" by Dennis W. Riley, Trusts and Estates, Sept., 1995. See also "Planning for Lapsing Rights and Restrictions - The Impact of Section 2704 on Valuation" by Jerald David August THE JOURNAL OF TAXATION, June, 1995.

(3) The 2704 final regulations define lapse of a voting right separately from lapse of a liquidation right.

(a) "Lapse of a Voting Right. A lapse of voting right occurs at the time a presently exercisable voting right is restricted or eliminated." Reg. § 25.2704-1(b).

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(b) This definition comports with the commonly understood meaning of "lapse", that is, the "restriction or elimination" of a right. Clearly the transfer of voting stock (or general partnership interests) resulting in a shift of the voting right from the transferor to the transferee is not a lapse. This is confirmed by EXAMPLE 4 of Reg. 25.2704-1(f):

"Example 4. D owns 84 percent of the single outstanding class of stock of Corporation Y. The bylaws require at least 70 percent of the vote to liquidate Y. D gives one-half of D's stock in equal shares to D's three children (14 percent to each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y, because the voting rights with respect to the corporation are not restricted or eliminated by reason of the transfer."

(c) The definition of a lapse of a liquidation right in Reg. 25.2704-1(c) equates a lapse with a transfer, viz:

"(c) Lapse of liquidation right-(1) In general. A lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. Except as otherwise provided, a transfer of an interest that results in the lapse of a liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated. However, a transfer that results in the elimination of the transferor's right or ability to compel the entity to acquire an interest retained by the transferor that is subordinate to the transferred interest is a lapse of a liquidation right with respect to the subordinate interest." Reg. Sec. 25.2704-1(c).

The preceding creates a potential exposure if a client has retained preferred partnership interest and also subordinate or junior partnership equity. It is only a problem if the general partnership interest is disposed of, or death occurs while the client still owns the subordinate (or junior) partnership equity. See EXAMPLE 5 under Reg. 25.2704-1(f) which is very close to the facts of the *Harrison* case involving a partnership redeeming a deceased general partner's interest rather than the other partners purchasing it as in *Harrison*. But in either event, such purchase or

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redemption is at liquidation value (presumably fair market value) of such general partnership interest.

This Regulation is contrary to the case law on transfers subject to estate tax inclusion, which limited retained powers causing estate tax inclusion to a power over the transferred property itself.

(4) It should be reasonably easy to avoid an inadvertent 2704(a) lapse if we could rely on the admittedly complex and difficult provisions of 2701 and 2704. Unfortunately, Internal Revenue Service is applying a "facts and circumstance" test as shown by PLR 9352001 which invoked a lapse under 2704(a) where a corporate recapitalization created voting and nonvoting stock with identical dividend rights. However, a son-in-law was given two shares of voting stock and an employment agreement with unreasonably high compensation. PLR 9352001 concludes on these facts that the nonvoting common shares retained by the transferor are "subordinate" within the meaning of 2704(a). As the *Byrum* majority opinion points out, if salary and compensation is excessive, Internal Revenue Service has income tax remedies to correct the excess.

Reg. Sec. 2704-1(a)(vi) incorporates the definition of "subordinate" contained in Reg. 25.2701-3(a)(2)(iii) which states:

"(iii) Subordinate equity interest. Subordinate equity interest means an equity interest in the entity as to which an applicable retained interest is a senior equity interest."

An Applicable Retained Interest is a non-cumulative distribution right or a liquidation, put, call or conversion right. PLR9352001 concludes that such precisely defined "rights" include excessive salary paid to the transferee of voting stock. A court would hopefully disagree with the Internal Revenue Service's strained interpretation of statutorily defined terms.

(5) Avoiding a 2704(a) lapse should be possible by:

(a) Not retaining any subordinate interest.

(b) Preventing the family from having liquidation power after the transfer by including an unrelated partner (such as a charity with a veto power over liquidation i.e. by requiring consent of all partners (one of whom is not a

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"family member") for liquidation.

(c) Rights valued under 2701 to the extent necessary to prevent double taxation.

(d) Changes in state law.

See Reg. 25.2704-1(c)(2).

(6) If faced with a 2704(a) alleged "lapse" of a liquidation right in respect to the subordinate interest under the Internal Revenue Service Regulations, the Taxpayer would have a strong defense from (i) the plain language of 2704(a); (ii) the fact that the lapse was not part of the subordinate equity interest as per the *Boykin* case analogy; and (iii) a constitutional defense that no transfer has occurred — there is no transferee. Neither Congress nor the Internal Revenue Service by Regulation can cause a non-transfer to be taxed as a transfer. See *N.Y. Trust Co. V. Eisner* (1921) 265 U.S. 345, *Knowlton v. Moore* (1900) 178 U.S. 41 and the "due process" theory of *Heiner v. Donnan*, (1932) 285 U.S. 312.

(7) If a 2704(a) lapse occurs, the statute imposes a "deemed" transfer for gift tax purposes (or estate tax in the case of a decedent) in an amount equal to the excess of:

(a) The value of all partnership interests held by the Transferor (or decedent) immediately before such lapse, over

(b) The value of such interests immediately after such lapse.

(i) This "deemed" transfer may have constitutional problems if there is no “transferee” whose net worth has been increased by such lapse.

(ii) If there is no identifiable transferee, there are problems in respect to responsibility for paying the tax if the donor or decedent's estate lacks sufficient funds. Who could be the transferee for IRC transferee tax liability purposes?

(iii) Some commentators suggest that there may be no excess value in the "before and after" lapse measurement under 2704(a) because a donor or decedent can only transfer a bare

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"assignee" interest in the partnership unless the partnership agreement gives a right to transfer partnership interest greater than state partnership law.

(8) Use a corporate general partner or two or more individual general partners to avoid 2704(a) lapse upon the death of individual general partner. Have a charity or other unrelated limited partner who can block liquidation after the transfer.

2. Section 2704(b) deals with a gift of an interest whereby the transferor retains control of by disregarding the restriction.

a. An "applicable restriction" is a restriction that limits the entity's ability to liquidate and either (i) the restriction lapses after transfer or (ii) the transferor effectively controls the right to remove the restriction. An applicable restriction does not include any restriction imposed by federal or state law or a commercially reasonable restriction imposed by the third-party lender on the partnership.

b. Regs. § 25.2704-2(d) provides two examples of "applicable restrictions" in the partnership context:

(1) "Example 1. D owns a 76 percent interest and each of D's children, A and B, owns a 12 percent interest in General Partnership X. The partnership agreement requires the consent of all the partners to liquidate the partnership. Under the State law that would apply in the absence of the restriction in the partnership agreement, the consent of partners owning 70 percent of the total partnership interests would be required to liquidate X. On D's death, D's partnership interest passes to D's child, C. The requirement that all the partners consent to liquidation is an applicable restriction. Because A, B and C (all members of D's family), acting together after the transfer, can remove the restriction on liquidation, D's interest is valued without regard to the restriction; i.e., as though D's interest is sufficient to liquidate the partnership."

(2) "Example 4. D and D's children, A and B, are partner's in Limited Partnership Y. Each has a 3.33 percent general partnership interest and a 30 percent limited partnership interest. Any general partner has the right to liquidate the partnership at any time. As part of a loan agreement with a lender who is related to D, each of the partners agree that the partnership may not be liquidated, without the lender's consent while any portion of the loan remains outstanding. During the

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term of the loan agreement, D transfers one-half of both D's partnership interests to each of A and B. Because the lender is a related party, the requirement that the lender consent to liquidation is an applicable restriction and the transfers of D's interests are valued as if such consent were not required."

(3) Internal Revenue Service contends that any restriction contained in a partnership agreement that is more restrictive than the state partnership law is an "applicable restriction" for purposes of 2704(b).

Md. C.&A. 10-201(4) requires a certificate of limited partnership to set forth "the latest date upon which the limited partnership is to dissolve." The 1998 Amendment adds: "And if no dissolution date is stated in the Partnership Agreement, subject to the provisions of Section 10-801 of this Title, the limited partnership shall have perpetual existence, which shall be so stated in the certificate."

(4) As amended in 1998, Md. C.&A. 10-603 provides:

"Withdrawal of limited partner. A limited partner may withdraw from a limited partnership at the time or on the happening of events specified in the partnership agreement. If the partnership agreement does not specify the time or the events on the occurrence of which a limited partner may withdraw, a limited partner may not withdraw before the dissolution on winding-up of the limited partnership."

(a) Before the amendment, a limited partner could withdraw upon 6 months notice if the agreement did not spell out a different rule. A potential issue for a Maryland LP or LLLP under prior law had been whether stating a term longer than 6 months in the certificate and/or the partnership agreement is an "applicable restriction" under 2704(b). The 1998 Amendment should eliminate this concern.

(b) Even in the absence of the 1998 statutory changes, most commentators conclude that a term longer than six (6) months should not be an applicable restriction because:

(i) State law required that a term be stated on the certificate.

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(ii) The term stated is not a restriction on liquidation, but a restriction on continuing the partnership beyond the stated term.

(iii) A stated term longer than 6 months is consistent with sound business and commercial agreements and would conform with 2703.

(iv) A partner can only transfer an "assignee" interest. Admission as a partner requires the consent of all partners. Md. C.&A. Secs. 10-702 and 703. So 2704(b) may be irrelevant. A willing buyer would surely consider the fact that he or she might not be admitted as a partner and would have no voting or liquidation rights – only the rights of a mere assignee of the partnership interest.

(v) In *Kerr v. Comm.*, 113 T.C. No. 30 (1999), the Tax Court rejected the distinction between the transfer of an assignee interest and a limited partnership interest stating that the distinction lacked economic substance. The Court then rejected the application of the restriction on liquidation to a restriction on a partner withdrawing stating that the provision only related to a liquidation of the entity not a partner's interest therein. *Kerr* was affirmed by the 5th Circuit on grounds other than whether the partnership itself constituted a restriction on liquidation. See however, *Jones v. Comm.*, 116 T.C. 121 (3/6/01), discussed below, reiterating the *Kerr* approach that the partnership itself is not a restriction on liquidation under § 2704 (b).

(vi) Internal Revenue Service never alleged any abuse from the fact that a corporate shareholder has no right to withdraw, so why the concern about partners withdrawal rights?

c. 2704(b) does not apply to commercially reasonable restrictions imposed by an unrelated lender. 2704(b)(3)(A). Obviously, a lender does not want its partnership borrower to liquidate, so financing arrangements usually would restrict liquidation.

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4. Even if 2704(b) disregards a restriction on liquidation, the withdrawing partner may not be entitled to a proportionate share of the asset value of the Partnership.

   a. Md. C.&A. Sec. 10-604 provides that unless otherwise provided in the partnership agreement, a withdrawing partner is entitled to receive the "fair value" of his or her partnership interest as of the date of withdrawal. The 1998 Amendment will base fair value "on the partner's right to share in distributions from the limited partnership" thereby eliminating argument by the Internal Revenue Service that fair value is a liquidation value based on the value of the partnership's assets. Similar changes to the Maryland LLC statute were made in 1997.

   b. Md. C.& A. Sec. 10-604 "fair value" may be considerably less than "liquidation value." *Warren v. Balto. Transit Co.*, 220 Md. 478 (1959) determined "fair value" in the context of dissenting minority shareholders, stating:

      "The real objective is to ascertain the actual worth of that which the dissenter loses because of his unwillingness to go along with the controlling stockholders, that is, to indemnify him. The text-writers and cases agree generally that this is to be determined by assuming that the corporation will continue as a going concern – not that it is being liquidated – and on this assumption by appraising all material factors and elements that affect value, giving to each the weight indicated by the circumstances, including the nature of the business and its operations, its assets and liabilities, its earning capacity, the investment value of its stock, the market value of the stock, the price of stocks of like character, the size of the surplus, the amount and regularity of dividends, future prospects of the industry and of the company, and good will if any."

      In the *Warren* case the difference between liquidation value and "fair value" was substantial. Testimony estimated liquidation value at a high of $177.50 per share to a low of $85.00 per share. But the going concern value high was only $15 per share and the low $10 per share.

   c. *Estate of Lucille M. McCormick v. Comm.*, 70 T.C.M. 318 (1995) discounted decedent's general partnership interest substantially below liquidation value. The Court concluded that a willing buyer, even if admitted as a general partner, would not buy an interest in the partnership with the intent to force liquidation. The combined marketability/minority discounts for the decedent's general partnership interests in the various Partnerships ranged from 38% to 54%. Taxpayer did not make the McClendon "assignee" argument.

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d. *Estate of McClendon v. Comm.*, 96-1 U.S.T.C. 18 (5th Cir. 1996, unpublished) held that under state partnership law (Texas – same as Maryland), a partner could only transfer an "assignee" interest, not a partnership interest. Therefore, only the value of an assignee interest is subject to a gift or estate tax. *Kerr*, supra., seems to hve rejected that assignee interest distinction, however, in the same circuit.

5. Whether a retained liquidation right forces use of a valuation based on the underlying assets is far from certain:

a. The legislative history of Chapter 14 would suggest that § 2704 was not to impact discounts in general: "These rules (regarding restrictions and lapsing rights) do not affect minority discounts or other discounts available under present law." Report of the Managers of the Conference Committee on the Omnibus Budget Reconciliation Act of 1990. Also, in Example 8 in the Conference Committee Report: "the value of mother's partnership interest in her estate is determined without regard to the (lapsing) restriction. Such value would be adjusted to reflect any appropriate fragmentation discount."

(1) Justice Scalia notwithstanding, the legislative history ought to be useful in supporting discounts regardless of § 2704 issues raised at audit.

b. Also: "Even if the appraiser is to disregard restrictions on liquidation which are greater than state law, the *Campbell* case indicates that the appraiser, giving appropriate weight to asset value and capitalization income, should seek to establish a 'true' value for the entity. *Estate of Catherine Campbell v. Commissioner*, 12 T.C.M. 1739 (1992) [. . . courts should not restrict consideration to only one approach to valuation, such as capitalization of earnings or net asset values. Certainly, the degree to which the corporation is actively engaged in producing income rather than merely holding property for investment purposes influences the weight to be given to the values arrived at under the different approaches, but it should not dictate the use of one approach to the exclusion of another.]" *Gibbs*, supra., at ¶ 1508.5, 15-106.

III. The "Anti-Abuse" Rules: An Omen or a Misfired Regulatory Shot?

1. I.R.S. Regs. § 1.701-2 (an income tax regulation) provides general rules designed to impose a substance-over-form rule on partnerships for income tax purposes.

a. Generally these rules require that the partnership is bona fide and that the transactions accurately reflect the partners' economic agreement.

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b. In the regulations, two examples raised questions as to whether § 701 was to be extended to estate and gift tax treatment of family partnerships.

(1) The Internal Revenue Service has announced that it will amend the final regulations and withdraw the two examples because the anti-abuse regulations are restricted to income tax treatment of partnerships. Ann. 95-8.

(2) Nevertheless, these two examples may reappear in the future in the gift and estate tax arena, so they are worth keeping in mind:

(a) "Example 5. Family partnership to conduct joint business activities; valuation discount; use of partnership consistent with the intent of subchapter K.

(i) H and W, husband and wife, form limited partnership PRS by contributing their interests in actively managed, income-producing real property that PRS will own and operate. H holds a general partnership interest, and W holds a limited partnership interest. At a later date, W makes a gift of a portion of her limited partnership interest. At a later date, W makes a gift of a portion of her limited partnership interest to each of H and W's two children S and D. Appropriate discounts, consistent with the taxpayers' treatment of the arrangement as a partnership, were applied in determining the value of W's gifts to the children.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. Although PRS is owned entirely by related parties, the decision to organize and conduct business through PRS under these circumstances is consistent with this intent. Therefore absent other facts (such as the creation of the partnership immediately before the gifts by W), the Commissioner cannot . . . recast the transaction.

The special valuation rules provided under Chapter 14 of the Code, in particular section 2701, prescribe certain special rules in valuing gifts of family controlled partnership interests. These special rules clearly contemplate that a bona fide partnership like PRS be treated as an entity and not as an aggregate of

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its partners for that purpose.

(b) Example 6. Family partnership not engaged in bona fide joint business activities; valuation discount; use of partnership not consistent with the intent of subchapter K.

(i) H and W, husband and wife, form limited partnership PRS and contribute to it their respective interests in their vacation home. H holds a general partnership interest, and W holds a limited partnership interest. At a later date, W makes a gift of a portion of her limited partnership interest to each of H and W's two children, S and D. Discounts, consistent with the taxpayers' treatment of the arrangement as a partnership, were applied in determining the value of W's gifts to the children.

(ii) PRS is not bona fide and there is no substantial business purpose for the purported activities of PRS."

IV. Federal Estate Tax Inclusion Considerations.

A. Retained powers under 2036(a)(1). Retention by the donor of a general partnership interest or voting stock is not a 2036(a)(1) retention of possession or enjoyment of, or the right to the income from, the transferred property.

1. Internal Revenue Service's defeat in _Boykin v. Commissioner_, 53 T.C.M. 3454 followed by the enactment and retroactive repeal of IRC Sec. 2036(c) with its estate tax inclusion model, and now the gift tax valuation approach of Sec. 2701 should discourage Internal Revenue Service from pursuing federal estate tax inclusion based upon the retention of income rights in a family limited partnership or other business entity. Nevertheless, caution must be exercised.

2. In a preferred partnership, it would be prudent to not retain 100% of the partnership profits, income or cash flow even if limited to a fixed dollar amount. Such total income retention might encourage Internal Revenue Service to argue for estate tax inclusion under 2036(a)(1) on the theory that the income of the transferred property has been retained by the transferor. Conceivably this could be a problem with Guaranteed Payments or Preferred Distribution Rights set at such high levels as to consume _all_ of the income of the partnership. Although this should not cause an inclusion under 2036(a)(1) if the Guaranteed Payments or Preferred Return is based on a reasonable return for the capital and risk. Nevertheless, it would be prudent to structure the partnership distribution arrangement so that there is a sharing of profits and/or cash flow from the outset. This sharing can be accomplished by a tiered system of preferential distributions.

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3. 2036(a)(1) also creates a risk if any beneficial use or enjoyment of the property of the partnership or business entity is retained by the transferor, for example, by living on or using the partnership property without full fair market value rent. See Estate of Dupont v. Commissioner, 63 T.C. 746 (1945) and cases cited therein. Rev. Rul. 7837003, Rev. Ruling 7842005 and the numerous other cases and Revenue Rulings dealing with retained beneficial enjoyment, "substance over form," sham, etc.

   In Reichardt v. Comm., 114 T.C. 144 (2000) the Court ignored the partnership because of an implied agreement in the family that the decedent could retain use of partnership property just as he had before forming the partnership. The partnership included a residence that the father/transferor lived in rent free and the father/transferor retained all of the income from the other assets. Also see, Schauerhamer v.Comm., T.C. Memo 1997-244. See also, Knight v. Comm., 115 T.C. 506 (11/30/00) discussed below where the retained control was not enough to trip a § 2036(a) inclusion. There can be no doubt that retained beneficial enjoyment is a fruitful IRS attack position, however: Thompson v. Comm'r, T.C. Memo 2002-246; Strangi; an appeal as Gulig (5th Cir. 6/17/02); all discussed below.

B. IRC Secs. 2036(a)(2) and 2038(a)(1) Right to Designate Persons Who Shall Possess or Enjoy the Property or the Income Therefrom. 2036(a)(2) is usually considered in conjunction with 2038(a)(1) which includes in the grantor's gross estate the value of property transferred by trust or otherwise if the grantor has retained the right to alter, amend, revoke or terminate the enjoyment of the transferred property.

   1. Case law has often applied 2036(a)(2) and 2038(a)(1) in cases where a settlor of a trust serves as trustee with fiduciary powers to determine the amount and/or timing of distributions from the trust, or the allocation of income between the income beneficiaries and remainderman. See U. S. v. O'Malley, 383 U.S. 627 (1966) and Lober v. U.S., 346 U.S. 335 (1953).

   2. Cases have recognized, however, that a settlor's retention of mere managerial or administrative powers will not cause inclusion under 2036 or 2038. See Old Colony Co. v. U. S., 423 F.2d 601 (1st Cir. 1970). A settlor/trustee could even retain control over trust distributions if such power retained by the settlor/trustee is subject to an "ascertainable standard." See Leopold v. U. S., 510 F.2d 617 (9th Cir. 1975).

   3. On first impression it might appear that the power of a general partner to distribute or retain partnership profits and assets would, if held by the settlor of a trust, be sufficient to cause inclusion under 2036(a)(2) and 2038(a)(1). Fortunately such estate tax inclusion is prevented by the important distinction articulated by the Supreme Court in U. S. v. Byrum, 408 U.S. 125 (1972) that the business interest effectively imposes an ascertainable standard on the

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Transferor's exercise of such fiduciary power.

4. In a series of Private Letter Rulings the Internal Revenue Service has consistently followed the *Byrum* distinction between fiduciary powers held as a majority shareholder or director of a corporation (or a general partner) and fiduciary powers held by the settlor of a trust. See T.A.M. 9131006, PLR 9310039 (involving a limited partnership created with a business purpose to invest partnership funds in stocks and securities for long-term growth), PLR 9415007 and PLR 9546006.

5. Internal Revenue Service appears to be increasingly suspicious of family limited partnerships as evidenced by the withdrawn EXAMPLES 5 and 6 to the regulations under Section 707. The *Byrum* case is the key to avoiding federal estate tax inclusion under 2036 or 2038 by reason of a general partner's broad management power. It would be prudent in drafting partnership agreements to (i) clearly indicate that the general partner has a fiduciary duty to the partnership and to the other partners in exercising all managerial powers of a general partner, and (ii) avoid giving the general partner such sweeping powers or exoneration of liability that could weaken or eliminate the general partner's fiduciary duties.

    a. Although it is comforting to have this long line of favorable TAMs and PLRs in respect to this 2036/2038 issue, T.A.M.s and PLRs are not legal authority and cannot be relied upon.

    b. The *Byrum* exception for powers retained in the business context has been affirmed by the Internal Revenue Service in PLR 9546006 issued 11/17/95. In this ruling, the Internal Revenue Service acknowledges that the general partner has a fiduciary duty to the limited partners. As a result, a general partner may not abuse the powers of the general partner to the detriment of the partnership or the limited partners. The allocation of income and losses among the partners are provided for in the agreement and the general partner does not have the ability to alter these allocations and therefore, does not have the right to designate the persons who shall enjoy the property or the income of the partnership within the meaning of 2036(a)(2).

    c. PLR 9546006 further acknowledges that the general partner has not retained the power to alter, amend, revoke or terminate the enjoyment by the limited partners of their interest in the partnership within the meaning of 2038(a)(1).

    d. At root of course, the distinction between the *Byrum* approach for a partnership and estate tax inclusion is the existence of a bona fide business purpose for the partnership. In Letter Ruling 20004022 the Internal Revenue Service ignored partnership status when a residence

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was placed in the partnership to permit IRC § 121 "roll-out" treatment. In that Ruling, the Internal Revenue Service held the partnership simply did not exist for federal tax purposes unless the parties in "good faith and with a business purpose, intend to join together in the present conduct of an enterprise and share in the profits or losses of the enterprise."

6. A precursor to the *Byrum* approach of superimposing an objective ascertainable standard to "control" held in a business context was expressed in the family partnership income tax rules. See Legislative History to IRC 704(c)(1) S. Rep. No. 781, 82nd Congress 1st Session 40, 1951. Retained controls are not detrimental if they are incident to normal continuing business relationships. It confirms the reality that business and economic requirements impose ascertainable standards on the transferor's retained management powers over a transferred business interest.

7. Maryland law historically imposed strict fiduciary standards on partners. *Allen v. Steinberg*, (1966) 244 Md. 119 imposed a duty of the "utmost good faith." As of 2003, however, the provisions of Maryland statutory law is somewhat ambiguous. Prior to 2003, the Uniform Partnership Act ("UPA") "defined" the obligations of a general partner in a limited partnership. Such definition was generally left to the Common Law. Effect December 31, 2002, however, the Revised Uniform Partnership Act ("RUPA") supplanted the UPA. Under the RUPA, the general partners' duties were, for the first time, spelled out rather than left to the common law and, by its terms, the RUPA was no longer "coupled" to the limited partnership act. A committee consisting of the Business Law, Taxation, and Estates and Trusts Sections of the Maryland State Bar Association reviewed the Re-Revised Uniform Limited Partnership Act (2001) which had been updated to reflect the decoupling that occurred with ReRULPA. Under § 408, "General Standards of General Partnerships' Conduct" the commissioners for the Uniform Act provided that the only fiduciary duties a general partner would have to the limited partnership or to the other partners would be the duties of loyalty and care. Additionally, those duties were truncated by that article. The committee suggested changes to the 2001 Uniform Act § 408 to provide: "A general partner has a fiduciary duty not to withhold distributions of partnership cash flow to the partners beyond the reasonable needs of the partnership to maintain adequate reserves for liabilities and future expenditures. This duty may be waived or altered by the partnership agreement." The proposed revision to the Uniform Limited Partnership Act was not introduced in the 2003 Session of the General Assembly. Regardless of whether or not such act would become law it would be prudent to put in any limited partnership agreement an obligation for the general partners to have *Byrum* type fiduciary standards.

8. See *Hackl* and PLR 9751003, discussed below, for the penalty for sidestepping the fiduciary duty.

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C. Estate Tax Inclusion under 2036(b). This is the "anti-*Byrum*" amendment to 2036, intended to reverse the *Byrum* rule in respect to voting rights directly or indirectly retained by the transferor in the stock of a controlled corporation. 2036(b) does not expressly apply to partnerships -- only to a retained power to vote stock of a controlled corporation. The Senate Committee Report on P.R.95-600, i.e. 2036(b), clearly indicates that retaining voting stock and transferring nonvoting stock is not subject to inclusion under 2036(b).

1. Concern has been expressed that controlled stock transferred to a partnership might be brought within the scope of 2036(b) on the theory that the general partner has indirectly retained the power to vote such shares. One PLR has held that a partnership wrapper was over closely-held stock fails as "indirect" control of voting rights. TAM 199938005. The case involved settled after being docketed. *Coulter v. Comm.*, T.C. Dkt. No. 17458-99 (filed 11/17/99; settled 11/23/01).

2. This potential 2036(b) exposure can be eliminated by recapitalizing the corporation and transferring only non-voting stock to the FLP, if the parent is to be the general partner, or have someone other than the original owner of such controlled corporation stock serve as the general partner.

V. Gift Tax Annual Exclusion Considerations.

A. Background. IRC § 2503(b) permits an annual gift tax exclusion for "a present interest in property."

1. Gifts to a trust, absent a "Crummey Power" to withdraw the contribution to the trust are not present interests.

(a) Because the general partner controls the timing of distributions, are gifts of limited partnership interests analogous to gifts in trust? See, *Lober v. U.S.*, 346 U.S. 335 (1953), holding that a power limited to controlling the timing of distributions will cause inclusion under §2036(a)(2).

2. Various Internal Revenue Service rulings reject this analogy by arguing that the *Bryum*-type fiduciary duty of the general partner to the limited partners is undistinguishable from the duty the board of directors has to its shareholders.

(a) "The general partners had the right under the partnership agreement to determine the timing and method of the partnership distributions similar to the right of a corporate board of directors to declare and pay dividends. The general partners are also bound to a high standard of conduct toward limited partners similar to that of corporate boards of directors to shareholders…In the instant case, the powers possessed

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by the general partners under the partnership agreement, including control over partnership distributions, are common to most limited partnership agreements. The decedent, as general partner, possessed no powers that are not otherwise contained in the standard limited partnership agreement, regardless of whether the partners are related or not…In the instant case, the gifts of the partnership interests constituted outright gifts of ownership interests in a business entity. Each donee received the immediate use, possession and enjoyment of the subject matter of the gifts, the interests in the partnership. These interests entitled the donees to any current economic benefits generated by the property. In addition, the donees had the right at any time to sell or assign the interests (subject to a right of first refusal). Management and control of the partnership assets were vested in an individual, the general partner. However, as discussed above, strict fiduciary duties are imposed on the general partner. Such management powers, therefore, are not the equivalent of a trustee's discretionary authority to distribute or withhold trust income or property; powers which would generally result in characterization of a gift in trust as a future interest." PLR 9131006.

(b) The reasoning of this ruling parallels that used by the Supreme Court in _U.S. v. Byrum_, 408 U.S. 125 (1972).

(c) It was suggested that the existence of the right of the donee to transfer the interest (subject to a right of first refusal) is a key element in PLR 9131006 and therefore that a more restrictive transfer provision may cause a gift of a limited partnership interest to be treated as a future interest. "Family Limited Partnerships," Prac. Drafting, 3761, 3763 (Oct. 1994).

(d) Do not overwrite the partnership agreement. One TAM held that when the general partners had complete discretion as to making distributions, no present gift occurred. PLR 9751003 (8/28/97).

B. _Hackl v. Comm._, 118 T.C. No. 14 (3/27/02)

1. The Tax Court held that gifts of units of a family LLC did not qualify as annual exclusion gifts under IRC § 2503(b) because the gifts did not constitute present interests.

a. The Court held that the terms of the operating agreement "in their cumulative entirety, must largely dictate whether the units, at issue, conferred the requisite benefit (of a 'presently reachable economic benefit')."

2. The LLC was established by the father to invest in tree farms as a method of

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setting up a long-term growth investment. The operating agreement named the father as managing member for his lifetime or until removed and authorized him to name his successor.

(a) Available cash could be distributed at the discretion of the father and no member could demand any distribution in return of his or her capital contribution.

(b) Members could not withdraw from the LLC without prior consent by the managing member.

(c) No member could transfer his or her units without the prior written consent of the managing member.

3. The Court held that the prohibition on transfer, demand rights to return the capital contribution, withdrawal from the LLC, or right to trigger dissolution meant that gift lacked a present economic right. Also the fact that no income could be expended for years from the LLC with respect to the units was a factor.

4. There have been lots of comments suggesting how to avoid the _Hackl_ lack-of-present-interest problem. One would be to give the limited partner a right to transfer subject to a first right of refusal. This may only work if there is a market for the interest. Other suggestions include building in crummy-like powers to withdraw the donee's share of capital or give the donee a time-limited "put." These latter methods may, however, defeat the discount. A right to transfer coupled with a semi-realistic anticipation of distributions would seem to handle the present interest issue. For larger gifts, of course, _Hackl_ is not the focus in any event.

VI. Representative Cases and Rulings: Tenant in Common Cases.

A. _LaFrak v. Comm._, 66 T.C.M. (CCH) 1297 (1993) – Tenants-In-Common.

1. "A minority discount for an interest in real property may be allowed on account of the lack of control which accompanies co-ownership. _Estate of Campanari v. Commissioner_. However, a holder of a fractional interest in real property has the power to compel partition of property, which is not available with other types of shared ownership interests. Bittker & Lokken, Federal Income Taxation of Estates, Gifts, & Trusts, par. 135.3.4, at 135-41 (2d ed. 1993). Accordingly, Bittker & Lokken have suggested that the discount should reflect the cost of partition and the value of the interest secured thereby. Id. We have on several occasions considered the cost, uncertainty, and delays attendant upon partition proceedings as the basis for allowing a discount in valuing fractional interests in real property. _Estate of Pillsbury v. Commissioner_, T.C. Memo 1992-425; _Estate of Wildman v._

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Commissioner, T.C. Memo 1989-667; Estate of Youle v. Commissioner, T.C. Memo. 1989-138; Sels v. Commissioner, T.C. Memo 1986-501; see also Estate of Henry v. Commissioner, supra at 477. The marketability discount, by contrast, measures the diminution in value attributable to the lack of a ready market for the property. Ward v. Commissioner, 87 T.C. 78, 106-107 (1986). Accordingly, we will consider each discount separately."

2. The Court permitted a 20% minority discount and a 10% marketability discount.

B. Williams v. Commissioner, 75 TCM 1758 (2/12/98) -- Tenants in Common.

1. The Tax Court granted a 44% discount (consisting of a blending of a 20% marketability discount with a 30% lack of control discount) for a 50% tenant in common interest in timberland.

2. In this case, the Internal Revenue Service expert did not evaluate the standing timber to give an opinion of the worth of that primary asset or give an opinion as to the discount due to the partial interest in the asset held by the taxpayer. The expert did, however, admit on cross-examination that an undivided 50% interest has a limited market and that a fractional interest should be discounted. This case shows the importance of presenting the factual elements of the case for supporting one's valuation position.

C. Est. of Baird, 82 T.C.M. 666 (2001).

1. Husband and wife died within a year of each other holding tenant-in-common interests in timberland through separate revocable trusts. Large (60%) discounts were permitted based on lack of control and the delay in the ability to sell partial interests.

a. This case is tribute to good appraisal work. The discount was based on the Tax Court's following the taxpayer's expert who had "experience in the very marketplace under consideration." The Internal Revenue Service expert, moreover, had no qualifications to value farmland.

b. Also see Est. of Forbes, T.C.M. 2001-72 (3/23/01) (30% discount for a tenant in common interest.)

VII. Representative Cases and Rulings: Partnership and Other Entities.

A. Kimball v. US, 2003 US Dist. Lexis 523 (1/15/03).

1. Kimball was an estate tax case that involved a decedent with a 50% interest in an LLC general partner (the other 50% held by the decedent's son and

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daughter-in-law) and the decedent held a 99% limited partnership interest. The decedent was 96 years old at the time of her death. Two months before her death she formed the family partnership by having the LLC contribute 1% of the capital in exchange for the general partnership interest and the limited partner contributing 99% of the capital in exchange for limited partnership interest. The court pointed out that the term of the partnership was for 40 years which would make her 136 years of age when it terminated.

2. *Kimball* was a refund case brought in the District Court for the Northern District of Texas. The District Court held that there was no effective transfer of property to the partnership because the transfers failed to qualify for either of the exceptions under § 2036.

   First, the Court rejected that the decedent exchanged property for "money and money's worth" so as to come within the "bona fide sale" exception of § 2036. The District Court held that the decedent not only stood on both sides of the transaction but for all purposes "was both sides of the transactions." Thus, there was no arms length transfer. More to the point, of course, was the holding that an exchange of the underlying assets for a partnership interest was not adequate consideration.

3. The Court also held that the transfer violated § 2036: "Plaintiff contends that decedent did not have the power to take over the partnership because she had fiduciary duties. Plaintiff makes much of the Supreme Court case, US v. Bryum…in which the court held that § 2036 did not apply to a decedent who retained voting interest in several corporations. However, *Bryum* is not only distinguishable on its facts from our case, but was expressly overruled by congressional enactment of § 2036…Moreover, § 2.95 of the partnership agreement states: 'The general partner will not owe a fiduciary duty to the partnership or to any partner.'…assuming such fiduciary duties exist to whom does a partner which owns 99% of the partnership owe them? The fiduciary argument falls flat."

B. *Thompson v. Commissioner*, T.C. Memo 2002-246 (9/26/02).

1. In *Thompson*, the IRS attacked two partnerships that the decedent established, one for each child. The IRS claimed the full fair market value of the assets in the partnerships should be included in the decedent's gross estate based on (i) that the FLP lacked economic substance or (ii) that the decedent retained the economic benefit and control over the assets under § 2036(a). The court held for the IRS, noting the following:

   > "In this case, the circumstance surrounding establishment of the partnerships show that, at the time of the transfer, there was an implied agreement or understanding that decedent would retain the enjoyment and economic benefit of the

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> property he had transferred. Before the partnerships were formed, Betsy (decedent's daughter) sought assurances from the financial advisers that decedent would be able to withdraw assets from the partnerships in order to make cash gifts each year to his children, grandchildren, and great grandchildren. In late November 1993 after the partnership were formed, George (decedent's son) asked the advisers how decedent could get $40,000 out of the partnerships to give as Christmas presents. The implied agreement among decedent, Robert, Betsy, and George that decedent would retain the enjoyment and economic benefit of the transferred property is reflected also by the distributions made by the partnerships to decedent.
>
> * * *
>
> Here, decedent's outright transfer of the vast bulk of his assets to the partnerships would have deprived him of the assets needed for his own support. Thus, the transfers from the partnership to decedent can only be explained if decedent had at least an implied understanding that his children would agree to his requests for money from the assets he contributed to the partnerships, and that they would do so for as long as he lived. "

C. *Harper v. Commissioner*, T.C. Memo 2002-121 (5/15/02).

1. *Harper* involved another successful § 2036(a) attack by the IRS to include all of the partnership interests in the decedent's estate. In *Harper*, the court recited that the general purpose of § 2036(a) is to include in the decedent's gross estate transfers that are essentially "testamentary in nature." The court held that the term "enjoyment" contained in § 2036 is "synonymous with substantial economic benefit" and stated that this retention of benefit can be pursuant to an implied understanding even if such implied understanding is not legally enforceable.

2. The court found that there was retained enjoyment of the assets by the decedent based on certain indications of the implied understanding: (i) the commingling of funds which evidenced the lack of any degree of separation between the assets and the decedent, (ii) a history of disproportionate distributions to the decedent, and (iii) the "testamentary characteristics of the partnership agreement" which was seen by the fact that the "decedent continued to be the principal economic beneficiary of the contributed property after (the partnerships) creation."

3. The court also rejected the taxpayer's position that the cases (*Shepherd*, *Jones*, *Strangi*, *Harrison*, and *Church)* "established that a proportionate partnership interest constitutes per se adequate and full consideration for the contributed assets." Instead, the court looked at whether the partnership was

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a true pooling of assets or whether it was simply an estate planning vehicle.

4. It should be noted that *Harper* involved a tax planning attorney who seemed to have documented that (i) although he was sick that he was not making decisions based on end-life considerations and (ii) that he came up with a very good business purpose (asset protection which was a real consideration given some economic difficulties encountered by his daughter).

D. *Shepherd v. Comm.*, 115 T.C. 376 (10/26/00); aff'd 283 F.3d 1258 (11th Cir. 2002)

1. *Shepherd* was a gift upon creation case. In that case, a father contributed leased timberland and bank stock to a partnership which he had formed with himself as a 50% partner each of two sons holding 25% interest. Under these circumstances, the Tax Court concluded that the transfer of property to the partnership represented indirect gifts to each of the sons of undivided, 25% interests in the leased timberland and bank stock.

2. In *Shepherd*, the Court stated that a transfer to a partnership for less than full and adequate consideration may represent an indirect gift to the other partners. "Obviously, not every capital contribution to the partnership results in a gift to the other partners, particularly where the contributing partner's capital account is increased by the amount of his contribution, thus entitling him to recoup the same amount upon liquidation of the partnership. In the instant case, however, petitioner's contributions of the leased timberland and the bank stock were allocated to his and his sons' capital accounts according to their respective partnership shares."

3. The Tax Court permitted a 15% valuation for the gift of a partial undivided interest in the underlying property. Interestingly, a dissenting judge (Judge Beghe) would have denied any discount based on an "estate depletion" theory of gift tax where the value of the gift would be the loss to the donor not the gain to the donee.

4. The taxpayer appealed *Shepherd* to the 11th Circuit and the opinion was affirmed No. 01-12250 (11th Cir. 2002). See also TAM 200212006 when no discount was given on an indirect gift on formation where the property constituted publicly traded municipal bonds.

E. *Knight v. Comm.*, 115 T.C. 506 (11/30/00).

1. In *Knight* the Internal Revenue Service attacked the formation of a partnership as lacking economic substance. The taxpayers (parents) set up a family partnership with a management trust as the 1% general partner (wholly owned by the parents) and each parent holding 49.5% limited partnership interest. The partnership was funded with approximately $2

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Million of assets which included a ranch, residences, a municipal bond fund and treasury notes. There was a lack of record keeping, no management participation by the non-parent partners, or much other indication that the change of ownership had occurred. Nevertheless, the Tax Court upheld the taxpayer's claim that the partnership form must be respected: "Petitioners content that their rights and legal relationships and other of their children changed significantly when Petitioners formed the partnership, transferring assets to it, and transferred interest in the partnership to those children…, and that we must recognize the partnership for federal gift tax valuation purposes. We agree with the Petitioners. State law determines the nature of property rights and federal law determines the appropriate tax treatment of those rights. The parties stipulated that the steps followed in the creation of the partnership satisfied all requirements under Texas law, and that the partnership had been a limited partnership under Texas law since it was created. Thus, the transferred interests are interest in a partnership under Texas law. Petitioners have burdened the partnership with restrictions that apparently are valid and enforceable under Texas law. The amount of tax for federal estate and gift tax purposes is based on the fair market value of the property transferred…we do not disregard the partnership because we have no reason to conclude from this record that a hypothetical buyer or seller would disregard it."

2. Once funded the taxpayers each transferred a 22.3% interest to each of their two children. Thus, after the transfers, the children (in a children's trust) each held 44.6% and the parents each retained a 4.9% limited partnership interest (as well as holding the 1% general partnership interest). The taxpayers took a 44% discount for 709 purposes. This was based on a 10% portfolio discount, a 10% minority interest discount and a 30% lack of marketability discount which aggregated at 44%. The Tax Court set aside the evidence of the taxpayers expert based on the expert's use of inappropriate comparables and/or based on the lack of objective analysis: "We have rejected expert opinion based on conclusions which are unexplained or contrary to the evidence…an expert fails to assist the trier of fact if he or she assumes the position of an advocate…[the expert's] erroneously factual substance passed out on his objectivity." (Citations omitted). Instead, the Tax Court granted a 15% discount taking into account materials "in the record" related to closed-end bond funds.

3. The gifts of limited partnership interest were made pursuant to a transfer document that stated that each 22.3% gift was limited in value to $300,000. The Internal Revenue Service attacked this restriction as being a formula gift that is void as against public policy. <u>Commissioner v. Procter</u>, 142 F.2d 824 (4th Cir. 1944) and <u>Ward v. Commissioner</u>, 87 T.C. 78 (1986). "In <u>Procter</u>, the transfer document provided that, if a Court decided a value would cause a part of the transfer to be taxable, that part of the transfer would revert to the donor." The Tax Court, however, did not use the <u>Procter</u> analysis but

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factually distinguished the Knight situation as not being a formula gift but being a gift of a specific percentage interest in the partnership. Because the Tax Court found a 15% discount instead of a 44% discount, the Knights were liable for gift tax.

4. The Internal Revenue Service did not appeal Knight.

F. Strangi v. Commissioner, 115 T.C. 35 (11/30/00); Gulig v. Commissioner, 5th Cir., (6/17/02).

1. In Strangi, the partnership was formed under a power of attorney two months before the decedent's death. The decedent retained a 99% limited partnership interest. The decedent was also a 47% shareholder in the corporate general partner. The general partner held a 1% interest in the partnership. The decedent's children paid for the 53% interest in the corporate general partner. Much of the assets were marketable securities. Strangi (i) rejected a 2703(a) attack, (ii) rejected the gift on formation attack, and (iii) permitted a 31% discount. In reached its opinion, however, the majority clearly were not supportive of the extent of the discounts and suggested that it would have used an IRS §2036 attack per Reichardt v. Commissioner, 114 T.C. 144 (2000) but found that the Internal Revenue Service had not timely raised that argument in a timely fashion. It should be noted that there were spirited dissenting opinions that would have either found a gift on formation and/or set aside the transaction as under the Step-Doctrine (Murphy v. Commissioner, T.C. Memo 1990-472, 60 T.C.M. 645 (1990). The Internal Revenue Service has appealed Strangi to the 5th Circuit.

2. After expressed great skepticism as to the "business purpose" of the decedent establishing the partnership, the majority opinion found that form governed substance: "[The partnership] was validly formed under state law. The formalities were followed, and the preverbal 'i's' were dotted" and "t's were crossed". The partnership, as a legal matter, changed the relationship between the decedent and his heirs and the decedent's actual and potential creditors. Regardless of subjective intentions, the partnership has sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of the decedent's at death and we do not disregard it in this case."

3. As to the § 2703(a) attack the Court stated: "Respondent next argues that the term 'property' in section 2703(a)(2) means that the underlying assets in the partnership and that the partnership form is the restriction that must be disregarded. Unfortunately for respondent's position, neither the language of the statute nor the language of the regulation supports respondent's interpretation. Absence application of some other provision, the property included in the decedent's estate is the limited partnership interest and decedent's interest in [the general corporate partner]." The Court cited Kerr

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v. Commissioner, 113 T.C. 449 (1999) and *Church v. U.S.*, 268 F.3d 1063 (5th Cir. 7/18/01) (unreported decision) affirming per Curiam 85 AFTR 2d 2000-804, 2000 WL 206374 (W.d Texas 2000).

4. The majority opinion in *Strangi* also rejected the gifts on formation argument. This pointed out that, using the values reported by the Petitioners on the estate tax return, the decedent gave up property worth over $10 Million and received back a limited partnership interest worth less than $6.5 Million. Under those circumstances the Court stated, there would be no business purpose, only a donative one, to accept something radically worth less than what was given up. "Nevertheless, in this case, because we do not believe the decedent gave up control over the assets, his beneficial interest in them exceeded ninety-nine percent, and his contribution was allocated to his own capital account, the instinctive reaction that there was a gift at the inception of the partnership does not lead to a determination of gift tax liability. In a situation such as in *Kincade* [682 F.2d 1220 (5th Cir. 1982)], where other shareholders or partners have a significant interest in an entity that is enhanced as a result of a transfer to the entity or in a situation such as *Shepherd v. Commissioner*, 115 2C _____ (2000) (Slip Op. at 21), where contributions of a taxpayer are allocated to the capital accounts of other partners, there is a gift. However, in view of decedent's continuing interest in the [the partnership] and the reflection of the contributions in his own capital accounts, he did not transfer more than a minuscule portion of the value that would have been "loss" on the conveyance of his assets to the partnership in exchange for the partnership interest…the actual control exercised by [the decedent's agent], combined with the ninety-nine percent limited partnership interest in [the partnership] and the forty-seven percent interest in [the corporation general partner], suggest the possibility of including the property transferred to the partnership in decedent's estate under Section 2036. See, E.G., *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000). Section 2036 is not an issue in this case, however, because respondent asserted it only in a proposed amendment to answer tendered shortly before trial. Respondent's motion to amend the answer was denied because he it was untimely."

5. On appeal, the 5th Circuit reversed and remanded the case to Tax Court on the § 2036 argument. It in effect, however, affirmed all other the Tax Court's holdings other than the denial of the right of the IRS to amend to bring it's § 2036 argument. *Gulig v. Commissioner*, 5th Cir., (6/17/02)

G. *Simplot v. Commissioner*, 249 F.3d 1191 (9th Cir., 5/14/01), *Rev'g.* 112 T.C. 130 (1999).

1. The decedent was the son of the founder of J.R. Simplot Company, a large agro business that produces, among other things, french fried potatoes for McDonalds. The decedent owned 18 of a little more than 76 shares of the

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company's voting stock and about 4,000 shares of the company's 14,000 issued non-voting stock. Other siblings owned the rest of the voting stock and the non-voting stock was family held and held in an employee stock ownership plan. The Tax Court valued the voting stock independently from the total stock and gave it a very large premium based on the theory that voting control of the corporation must always be worth between 3% and 10% of the total value of the corporation regardless of how small a percentage the actual voting shares constitute of the overall stock.

2. The 9th Circuit, reversed the Tax Court holding and stated that the Tax Court should not attribute a premium to the minority block of voting stock: "The Tax Court committed a third error of law. Even a controlling block of stock is not to be valued at a premium for estate tax purposes, unless the Commissioner can show that a purchaser would be able to use the control 'in such a way to assure an increased economic advantage worth paying a premium for.' _Ahmanson Foundation v. United States_, 674 F.2d 761, 770 (9th Cir. 1981). Here, on liquidation, all Class B shareholders would fare better than Class A shareholders; any premium paid for the 18 Class A shares be lost. Class A and B had the right to the same dividends. What economic benefits attended 18 shares of Class A stock? No 'seat at the table' was assured by this minority interest; it could not elect a director. The Commissioner points out that Class A shareholders had formed businesses that did business with _Simplot_. If these businesses enjoyed special advantages, the Class A shareholders would have been liable for breach of their fiduciary duty to the Class B shareholders. See _Estate of Curry v. United States_, 706 F.2d 1424, 1430 (7th Cir. 1983)."

H. _Estate of Jones v. Commissioner_, 116 T.C. 121 (3/6/01).

1. In _Jones_ a father set up two partnerships: (i) one with his son and (ii) one with his four daughters. The father transferred real property to each of the partnerships and the children likewise contributed real property to the partnerships. The value of the father's contribution, however, was greatly disproportioned to the value of the children's contributions. In the partnership with the son, for example, the father held a 95.5% limited partnership interest and an 88% limited partnership interest in the daughters' partnership. The son received a 1% general partnership interest and the daughters (collectively) received a 1% general partnership interest in exchange for their contributions and the remaining limited partnership interests. Immediately after formation, the father transferred by gift an 83% limited partnership interest to his son and approximately a 17% in the partnership interest to each of his four daughters in the second partnership.

2. The Court held that the transfer of property by the father into the partnerships did not constitute a gift on formation (citing _Strangi_) because all of the contributions were properly reflected in the capital accounts of the

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contributing partners.

3. The Court rejected the argument by the Internal Revenue Service that the partnership itself was a restriction under § 2704(b) applying <u>Kerr</u>.

4. The Internal Revenue Service, however, severely limited the discount of the interest to the son giving that transfer a mere 8% discount for lack of marketability because the holder of the majority limited partnership interest (the son) could remove the general partner, refuse to name a successor and force dissolution of the partnership. The Tax Court, on the other hand, permitted a 48% marketability discount for the gifts to the daughters because a 17% limited partner could not compel liquidation. The Tax Court rejected the taxpayer's argument that the transferred interest should be valued as "assignee interest" rather than partnership interest based on a factual finding that the donees had implicitly waived the requirement of consent to the admission of a new partner in this family setting. Unfortunately, the Court also rejected a discount due to the built-in gains because the hypothetical buyer would rightfully be able to have the general partner make a § 754 election to adjust the basis of the partnership asset on purchase.

I. <u>*Dailey Estate v. Commissioner*</u>, T.C. Memo 2001-263 (10/3/01).

1. <u>*Dailey*</u> involved a family limited partnership holding marketability securities, some of which include substantial unrealized capital gains. Mrs. Dailey gave limited partnership interests in the partnership to her son and daughter-in-law and valued the gifts by discounting the net asset value of the partnership by 40%. At the time, the son acquired control of the partnership and at his mother's death he was the general partner. The issue before the Court was the value of a 40% limited partnership interest held by the decedent at death. The sole issue addressed by the Court was the extent of the discount. Both experts compared the partnership to a closed-end mutual fund which trades at a discount to net asset value. The appraisers, however, disagreed to the amount of the discount. The Internal Revenue Service appraiser "could not recall" reviewing the partnership agreement and although admitted unrealized capital gain is an important element to the discount, he failed to review the documents to determine if the family limited partnership had an such gains. The Tax Court determined that: "Respondent's expert's testimony was contradictory, unsupported by the data, and inapplicable to the facts. We are 'not bounded by the opinion of any expert witness when that opinion is contrary to our own judgment'." <u>*Estate of Dilford v. Commissioner*</u>, 88 T.C. 38, 56 (1987). "Although neither expert was extraordinary, Petitioners' expert provided a more convincing… analysis than Respondent's expert. We conclude that an aggregate marketability and minority discount of forty percent is warranted and is applicable to the aforementioned interest." The taxpayers' expert gave an opinion that a 40% discount should be held.

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2. Part 2 of <u>Dailey</u> was a claim for litigation costs based on two positions by the IRS that were not substantially justified (1) its valuation position and (2) its position that the FLP should be disregarded for tax purposes. The taxpayer prevailed on the second point (but lost its valuation argument. The court held that valuation is difficult and the appraiser was qualified and the deficiencies of the appraisal were not revealed until cross-examination.

J. <u>Heck v. Commissioner</u>, T.C. Memo 2002-34.

1. This case involved the valuation of the minority share in the company that makes Corbel Champagne. The estate successfully argued that a market approach to value should not be used because there was only one company that could be a "guideline company" when fixing market value and more than one company must be found if using a market comparison. The Court then examined the discounted cash flow method used by the taxpayer and government's experts. This case is a good example of the necessity of looking at the underlying assumptions being made to analyze a company's books when basing valuation on that particular company's books.

K. <u>Mitchell Estate v. Commissioner</u>, 250 F.3d 696 (9th Cir. 3/21/01).

1. The decedent held 49% of the stock of a company he founded to market hair-care products. In the Tax Court, the estate's experts valued the stock between $20 Million and $30 Million. The Internal Revenue Service's experts valued the stock between $57 Million and $165 Million. The Tax Court found the value of the stock was approximately $31.5 Million. The methodology of the Tax Court was to take the value of the whole company at $150 Million then apply a 10% discount because of the death of the decedent as a key person and a 35% marketability and lack of control discount. It also added a small discount because of the potential of a lawsuit over the compensation of the other shareholder. The stock was held by a second shareholder who had the controlling interest. That shareholder had turned down an offer by Gillette to purchase the company at something close to $150 Million – the Tax Court's starting point on value.

2. The Court of Appeals reversed the Tax Court holding that the burden of proof had shifted to the Internal Revenue Service and that the evidence demonstrated that the Internal Revenue Service assessment was arbitrary and excessive. It faulted the Tax Court on its methodology: "The Tax Court, on the other hand, started with an acquisition value, the One Hundred Fifty Million bid by Gillette Co. and began discounting from there. Acquisition value and publicly traded value are different because acquisition prices involve a premium for the purchase of the entire company in one deal. Such a lump-sum valuation was not taken into account when the minority interest value of the stock was calculated by the experts." There are at least two problems with this methodology: that the Gillette offer was probably an offer

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by a strategic purchaser and therefore not indicative of fair market value and also the offer was rejected by the majority owner demonstrating rather dramatically that the minority owner has no power to get at the underlying value.

L. <u>*H. Morrissey v. Commissioner*</u>, 243 F.3d 1145 (9th Cir. 3/15/01) *Rev'g*; <u>*Kaufman v. Comm.*</u>, T.C. Memo 1999-119.

1. In <u>*Kaufman*</u>, in the Tax Court, the Internal Revenue Service rejected the use of two sales that occurred soon after the decedent's death.

2. In reversing, the 9th Circuit Court of Appeals said that the price which the same stock sells for between willing and knowledgeable buyers and sellers is dispositive unless there can be good reason shown to reject those sales: (i) the Commissioner tries to make something out of the family connection [of] the seller with the buyers. They were not especially close…the Commissioner notes [the buyer] was a very successful businessman, so that the Seminole stock may not have meant much to him. People don't get to be very successful in business by treating valuable property carelessly.

M. Field Service Advice 200049003 (9/1/00).

1. The Internal Revenue Service set out its position for agents in the field when examining valuation discounts in the context of a family limited liability company. This field service advice was written before <u>*Shepherd*</u>, <u>*Strangi*</u>, and <u>*Knight*</u> but released in late 2000 after those cases were decided. This FSA is a good thumbnail sketch as to the Internal Revenue Service's position and should be reviewed along with the cases as part of the planning, audit preparation or case defense procedure.

N. Valuation Benchmarks?

1. At the Miami Heckerling Institute in Miami, a U.S. Treasury official kicked off a controversy. Mary Lour Edelstein, national coordinator for the Internal Revenue Service Appeals office, stated that family limited partnership discounts (as upheld in appeals) where running thus:

a. FLP's with § 2036 "issues" and for death bed cases…0% - 15% discounts.

b. FLP's consisting of passive assets, including portfolio assets…25% - 30% discounts.

c. FLP's consisting of operating businesses or real estate…35% - 40% discounts.

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Obviously, these figures give practitioners benchmarks when dealing with auditors or, when second guessing appraisers. Ms. Edelstein's comments have been widely publicized.

2. The Internal Revenue Service – or at least the auditors – are reputing Ms. Edelstein's comments. At a New York Bar Association meeting held Spring 2003, an Internal Revenue Service representative has challenged Ms. Edelstein's remarks stating that the Internal Revenue Service has not established any rule of thumb as to the discounts.

3. The official policy may be that there are no discount guidelines, however, Ms. Edelstein was commenting on the results coming out of Appeals. She has had the various Appeals offices report to her since 1999 regarding the extent of the discounts in various types of cases. Thus, Ms. Edelstein's benchmarks probably reflect what is actually happening at the Appeals level. You do not get to Appeals, of course, unless you disagree with an auditor so the auditor may also be correct that at his level there is no consistent treatment.

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