RECENT CASES AFFECTING FAMILY LIMITED PARTNERSHIPS AND LLCs AND OTHER VALUATION ISSUES

Louis A. Mezzullo
Luce, Forward, Hamilton & Scripps LLP
Rancho Santa Fe, CA
lmezzullo@luce.com

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1. ***Estate of Keller v. U.S.,*** 96 AFTR 2d 2005 (D.C. TX, 2005)

a. Facts

This case involves a denial of the Commissioner's motion for summary judgment with regard to a refund claim for approximately $40,000,000 resulting from a claimed discount for limited partnership interests held in two trusts included in the decedent's estate. The Commissioner claimed (1) the trusts did not exist because they did not have a *corpus*, (2) the managing company that was the general partner of the limited partnership was not authorized to conduct business, (3) consequently the limited partnership never came into existence because it had neither limited partners nor a general partner, and, as such, (4) the assets were properly included in the decedent's estate. The Commissioner also argued that even if the limited partnership was formed, there were no assets in the partnership at the time of the decedent's death. Finally, and in the alternative, the Commissioner maintained that the assets of the partnership were included in the decedent's estate under Internal Revenue Code ("I.R.C.") §§ 2036(a) and 2038(a).

b. The Court's Opinion

The opinion points out a number of potential problems that the estate may have in substantiating the claimed transfers. Nonetheless, the issue on a motion for summary judgment is whether pleadings, depositions, answers to interrogatories, and admissions on file, together with affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. As the moving party, the Commissioner had the initial burden of informing the Court of all evidence demonstrating the absence of a genuine issue of material fact. The Court, however, had to view the evidence in a light most favorable to the estate, and draw all reasonable inferences in favor of the estate. The estate, however, could not avoid summary judgment simply by presenting "conclusory allegations and denials, speculation, improbable references, unsubstantiated assertions, and legalistic argumentation."

With regard to the issue involving the existence of the trust, the management company's authorization to do business, and whether assets were ever placed in the partnership, the Court found that all involved either factual inquiries or an insufficient basis for summary judgment.

As for the §§ 2036 and 2038 issues, the Court compared *Kimbell v. U.S.,* 371 F.2d 257 (5th Cir. 2004) with *Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005), noting that *Kimbell* was decided in favor of the taxpayer and *Strangi* in favor of the Commissioner. The Court concluded:

> Taken together, *Kimbell* and *Strangi* signify to this Court that summary judgment would be inappropriate in this case. Although the Court recognizes that plaintiffs face a heavy burden in ultimately establishing the applicability of the exception [the bona fide sale exception] or that neither § 2036 nor 2038 otherwise apply, the Fifth Circuit has clearly indicated that these issues turn on a detailed and thorough analysis of the facts of each case. As such, and considering the significant amount of refund at issue in this lawsuit, the Court finds that the prudent decision at this time is to allow the case to proceed to a trial on the merits, at which time the Court will be better positioned to evaluate all of the evidence in light of the Fifth Circuit guidance.

c. Analysis of the Court's Opinion

This case demonstrates the importance of complying with the formalities when creating trusts and other legal entities and transferring assets to such entities. Had taxpayers complied with the formalities, the Commissioner would have had no grounds to move for summary judgment on the formation issues. The fact that the taxpayer was successful in having the motion denied should not diminish the risk involved in not having dotted all the i's and crossed all the t's. The Court's conclusion as to the §§ 2036 and 2038 issues confirms how important the facts are in determining whether the IRS can successfully invoke those sections to disregard an entity.

2. ***Estate of Kelley v. Commissioner,*** T.C. Memo 2005-235

a. Facts

The decedent, who was in his 80's, died on December 8, 1999, owning a 94.83% limited partnership interest in the Kelley-Louden, Ltd., a limited partnership ("KLLP") and a one-third membership interest in the limited liability company ("LLC") that was the one-percent general partner of KLLP. According to the opinion, the estate claimed a 53.5% valuation discount, although the estate itself claimed that the discount was 55.15%. The limited partnership was created on

April 6, 1999, and between June 6 and September 13, 1999, the decedent transferred approximately $1.1 million of assets, 2/3 of which was cash and 1/3 of which were certificates of deposit, to the partnership and the LLC for a 94.83% limited partnership interest and a 1/3 membership interest. His daughter and son-in-law contributed cash to the partnership and the LLC for a 4.17% limited partnership interest and a 2/3 membership interest.

In its notice of deficiency, the Internal Revenue Service ("IRS") contended that the appropriate discount was 25.2%. The Court noted that in addition to the challenge to the discount, the IRS had raised a number of other arguments, including arguments based on I.R.C. §§ 2035, 2036, 2038 and 2703. At trial, the IRS conceded all the alternate grounds. While the Court did not discuss why the IRS dropped the other arguments, the attorney who handled the Tax Court case for the taxpayer indicated that the decedent had a physical exam about the time the partnership was formed that found him to be in good health for a person of his age, and that a family photograph was taken at Thanksgiving, less than two weeks before he died, that showed him to be bright eyed and rosy cheeked, a picture of good health. In addition, the decedent had his railroad retirement to support him.

b. The Court's Opinion

The Tax Court's opinion, written by Judge Vasquez, arrived at a combined 32.24% discount for lack of control and lack of marketability (12% lack of control and 23% lack of marketability). The lack of control discount was based on the arithmetic mean of all the closed-end funds, which the IRS' expert used, rather than the fourth quartile that represented the funds at the low end of demand and that traded at higher discounts, which the taxpayer's expert used. The lack of marketability discount was based on the private placement approach used by the IRS' expert rather than the restricted stock approach used by the taxpayer's expert. Because of the nature of the assets, the parties had agreed on the net asset value of the partnership.

c. Analysis of the Court's Opinion

The *Kelley* case is evidence that family limited partnerships and LLCs are alive and well if formed properly. Although the estate may have been disappointed with only a 32.24% discount, that is certainly better than no discount at all, which would have been the result had the IRS successfully invoked § 2036(a) or had the decedent and his family done nothing.

3. ***Estate of Blount v. Commissioner,*** T.C. Memo 2004-116, *aff'd in part and rev'd in part,* 96 AFTR 2d 2005-6795 (11th Cir. 2005)

a. Facts

Decedent and his brother-in-law were 50% shareholders of a construction company decedent's father had formed. They entered into a buy-sell agreement in 1981 providing for the purchase of a deceased shareholder's shares at a price determined by the shareholders, or, if no price was so determined, at book value determined at the end of the fiscal year preceding the shareholder's death. The agreement also restricted transfers during lifetime. In 1992, the company adopted an employee stock ownership plan (the "ESOP") and using company contributions the ESOP acquired shares from the company and the other two shareholders. Decedent's brother-in-law died in January 1996. At the time, the company owned $3,000,000 of life insurance on each of the shareholders' lives to fund the agreement. The company's book value on January 31, 1995 (the close of the company's fiscal year) was $6,400,000 and the brother-in-law's shares had a book value of approximately $3,000,000. The company redeemed the brother-in-law's shares for approximately $3,000,000, paying approximately $2,000,000 in cash and issuing a note for the balance.

In October 1996, the decedent discovered he had terminal cancer. He had the company's controller prepare an analysis showing the impact on the company of a redemption of his shares. One analysis showed that a purchase price of $4,000,000, payable in a lump-sum, would leave the company with sufficient cash to operate without the need for personal guarantees for the company's performance bonds. In November 1996, decedent and the company entered into a one-page agreement providing for the redemption of his shares at his death for $4,000,000 in cash payable in a lump sum. The 1996 agreement did not refer to the 1981 agreement. Decedent died in September 1997 and the company shortly thereafter redeemed his shares for $4,000,000 as required in the 1996 agreement, using the $3,146,134 life insurance proceeds received because of his death and additional cash on hand. After the redemption, the ESOP owned 100% of the outstanding shares.

At the time of the decedent's death, the value of the company according to the most recent appraisal done for the purposes of the ESOP was $8,000,000, suggesting that the value of the decedent's shares was approximately $6,700,000. In addition, the company's book value was approximately $9,000,000, suggesting that the value of the decedent's shares was approximately $7,500,000. The purchase price pursuant to the 1981 agreement would have been $7,600,000, based on the company's book value on January 31, 1996, had the decedent died before January 31, 1997. The estate reported the value of the decedent's shares on the federal estate tax return as $4,000,000. The IRS, in a notice of deficiency, determined the fair market value to be approximately $7,900,000, resulting in a $2,354,521 deficiency.

The sole issue in the case was the value for federal estate tax purposes of the decedent's shares in the company. Part of the issue was whether the buy-sell agreement, as modified by the 1996 agreement, fixed the value or should have been disregarded in determining the value for federal estate tax purposes.

b. The Tax Court's Opinion

Judge Gale, the trial judge, found the following:

(1) The 1981 buy-sell agreement, as modified by the 1996 agreement, did not satisfy the requirement under Treas. Reg. § 20.2031-2(h) that the agreement be binding during lifetime, because the decedent could unilaterally amend the agreement, and, therefore, it should be disregarded for purposes of determining the value of the shares for federal estate tax purposes.

(2) Because the 1996 agreement was a substantial modification to the 1981 agreement, the modified agreement was subject to I.R.C. § 2703.

(3) Because the terms of the agreement were not comparable to similar arrangements entered into by persons at arms length, the agreement should be disregarded.

(4) The value of the decedent's shares was $8,233,583, approximately $300,000 more than the value the IRS reported in the notice of deficiency, based on the company's value on the valuation date (decedent's date of death) of $9,896,134 (although the Court limited the amount assessed to the amount in the IRS' deficiency notice).

Judge Gale dismissed the opinion of one of the taxpayer's experts because it ignored the receipt of the $3,146,134 of life insurance proceeds and other cash and non-operating assets and was based on multiples of earnings of other companies whose characteristics were not similar to those of the company. The other taxpayer's expert's opinion was also found to be faulty because it reduced the value of the company's assets by $750,000 for the company's obligation to buy shares distributed to ESOP participants and excluded the life insurance proceeds in valuing the company because of the company's obligation to purchase the decedent's shares. Judge Gale correctly demonstrated that a willing buyer would take into account both the liability arising from the company's redemption obligation and the shift in proportionate ownership interest of the remaining shareholder resulting from the redemption.

Judge Gale explains the fallacy of the taxpayer's position as follows:

> By contrast, a hypothetical willing buyer of BCC shares other than decedent's would treat the redemption obligation, on the valuation date, as a corporate liability of BCC, but only in connection with a simultaneous accounting of the impact of the redemption of decedent's shares on the ownership interest inherent in the other shares not being redeemed.
>
> A simplified example will illustrate the fallacy behind the estate's contention that BCC's obligation to redeem decedent's shares

> should be treated as a liability offsetting a corresponding amount of corporate assets. Assume corporation X has 100 shares outstanding and two shareholders, A and B, each holding 50 shares. X's sole asset is $1 million in cash. X has entered into an agreement obligating it to purchase B's shares at his death for $500,000. If, at B's death, X's $500,000 redemption obligation is treated as a liability of X for purposes of valuing B's shares, then X's value becomes $500,000 ($1 million cash less a $500,000 redemption obligation). It would follow that the value of B's shares (and A's shares) is $250,000 (i.e., one half of the corporation's $500,000 value) upon B's death. Yet if B's shares are then redeemed for $500,000, A's shares are then worth $500,000—that is, A's 50 shares constitute 100-percent ownership of a corporation with $500,000 in cash.
>
> It cannot be correct either that B's one-half interest in $1 million in cash is worth only $250,000 or that A's one-half interest in the remainder shifts from a value of $250,000 preredemption to a value of $500,000 postredemption.
>
> The error with respect to B's shares in the example lies in the treatment of X's redemption obligation as a claim on corporate assets when valuing the very shares that would be redeemed with those assets. With respect to A's shares, a willing buyer would pay $500,000 upon B's death (not $250,000) because he would take account of both the liability arising from X's redemption obligation and the shift in the proportionate ownership interest of A's shares occasioned by the redemption -- but never the former without the latter. [Footnotes omitted]

Judge Gale rejected the IRS' contention that the 1996 agreement had supplanted the 1981 agreement, but instead held that it was a modification so that the terms of the 1981 agreement still applied, except to the extent that they were changed by the 1996 modification. Nonetheless, because the taxpayer agreed that the 1996 agreement only required the consent of the decedent and the company and not the ESOP, and because the decedent controlled the company, the decedent had the unilateral ability to modify the modified 1981 agreement, including the restrictions on lifetime transfers. Thus, the modified 1981 agreement was not binding on the decedent during his life.

Because Judge Gale found that the 1996 agreement was a substantial modification to the 1981 agreement, it was subject to I.R.C. § 2703. The modifications were (1) replacing book value as the redemption price with a fixed price of $4,000,000; (2) removing the automatic adjustment mechanism for adjusting the price annually based on book value; (3) eliminating the shareholders' right to set the price each year; and (4) precluding the right of the company to pay in installments. These changes were more than de minimis and affected the value, quality and timing of the shareholders' rights with respect to the shares covered by the agreement. Judge Gale rejected the taxpayer's contention that the modification resulted in a value that more closely approximated the fair market value because, after the redemption of the brother-in-law's shares, the decedent's shares had a value of at least $6,700,000 at the time the 1996 agreement was entered into.

Because the modified agreement did not satisfy all three requirements under the statutory exception to I.R.C. § 2703, it was disregarded in determining the value of the shares for federal estate tax purposes. Although the modified agreement satisfied the first two requirements, i.e., it was a bona fide business arrangement and it was not a testamentary device to pass the shares to the members of the decedent's family (or the natural objects of the decedent's bounty, as the regulations put it) for less than full and adequate consideration in money or money's worth, the taxpayer failed to demonstrate that the terms of the agreement were similar to arrangements entered into by persons dealing at arm's length. The Court noted that the taxpayer had the burden of proof because it failed to raise I.R.C. § 7491, which would have shifted the burden of proof to the IRS under certain circumstances. The Court also noted that the so-called "testamentary device" requirement was met because the beneficiaries of the arrangement were the participants in the ESOP, none of whom were found by the Court to be the natural objects of the decedent's bounty.

c. Analysis of the Tax Court's Opinion

From a technical standpoint, the Court's disregarding the modified buy-sell agreement in valuing the decedent's shares for federal estate tax purposes appears correct. Under the law before the adoption of I.R.C. § 2703, the buy-sell agreement had to bind a decedent during his lifetime in such a manner that the decedent was not free to dispose of his or her interest in the entity without first offering to sell it to the entity or other owners at the price specified in the agreement. Assuming that the Court was correct that the decedent and company were the only parties that had to consent to a modification, this requirement was not met. Even had the Court found that the ESOP had to consent to a modification, because the Court found the modified agreement was subject to I.R.C. § 2703, the agreement would still be disregarded because the Court found the terms were not comparable to an arrangement entered into at arm's length.

Whether the result would have been different had the taxpayer invoked I.R.C. § 7491 is not clear, but certainly the taxpayer would have had a better chance of proving its case if the burden had shifted to the IRS to prove that the terms were not comparable to arrangements entered into at arm's length. In addition, could the fact that the company and the decedent, as the majority shareholder, had a fiduciary duty to the participants in the ESOP, as the other shareholder, have created the necessary facts and circumstances to render the modified agreement an arm's length transaction? As a practical matter, it is unfortunate that the decedent's estate may end up paying additional estate taxes for value that benefited persons who were clearly, at least according to the Court, not objects of the decedent's bounty.

d. Planning Implications

At first it may seem that a buy-sell agreement that does not result in a benefit to the natural objects of the decedent's bounty, whether they be family members or others, should establish the value of an interest owned by the decedent in a business entity for federal estate tax purposes as long as it is binding at the decedent's death. However, the Blount case is a reminder that the requirements under the law in existence before the adoption of I.R.C. § 2703 must still be met and, if the agreement is subject to I.R.C. § 2703, the requirements under that section for either the statutory exception or regulatory exception must be satisfied. As for pre-1990 law, the modified agreement in Blount would have passed muster had the ESOP been a party to the modified agreement unless the Court could have found that the decedent also controlled the ESOP. Even though the decedent was one of the three trustees at the time of his death, the fiduciary duty of a trustee, particularly of a qualified retirement plan such as the ESOP, would have precluded such a finding.

With regard to I.R.C. § 2703, when there is no possibility that the benefit of the arrangement will pass to the natural objects of the decedent's bounty, the comparability requirement will be the requirement most likely to be an issue when the price under the agreement is deemed to be below the fair market value of the interest. Most likely, such an arrangement will still be a bona fide business arrangement. Of course, if the decedent and his or her family own less than 50% of the interest in the entity, the regulatory exception will apply and I.R.C. § 2703 will have no effect – only pre-1990 law will apply. Satisfying the comparability requirement will be easier if the taxpayer can shift the burden of proof to the IRS under I.R.C. § 7491. Nonetheless, if possible the lawyer advising the parties to a buy-sell agreement should endeavor to create a documentary record indicating the arm's length nature of the transaction. In *Blount*, the purported reason for arriving at the $4,000,000 purchase price in the modified agreement was to allow the company to continue to operate as it had before the decedent's death without the requirement for personal guarantees on the performance bonds typical of any construction company.

e. The Court of Appeals Opinion

While the Eleventh Circuit affirmed the Tax Court's holding that the amendment to the buy-sell agreement did not satisfy either the requirements before the enactment of I.R.C. § 2703 or the safe harbor under § 2703, it reversed the Tax Court's addition of the life insurance proceeds to the value of the company. Because of the contractual liability under the amended buy-sell agreement, the Eleventh Circuit concluded that the insurance proceeds were offset dollar-for-dollar by the company's obligation to satisfy its contract with the decedent's estate. In the Court's words:

> To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3,000,000 liability strains credulity and defies any sensible construct of fair market value.

What the Eleventh Circuit ignores is the fact that as a result of the company's purchase of the stock owned by the estate, the remaining shareholder's stock increased in value. For example, assume that the value of the company was $10,000,000. The remaining shareholder, the ESOP, owned 13% of the stock before the redemption of the estate's stock. Its pro rata share of the value of the company was $1,300,000. After the company redeemed the estate's stock for $4,000,000, the ESOP now owned 100% of the stock of the company, now presumably worth $6,000,000. Consequently, as a result of the redemption, the ESOP's stock increased in value by $4,700,000. By ignoring the insurance proceeds in valuing the company, the Eleventh Circuit does not take into account the increase in value of the remaining shareholder's stock as a result of the redemption.

4. ***Smith III v. U.S.***, 94 AFTR2d 2004-5283 (W.D. Pa. 2004); *rehearing,* 96 AFTR 2d 6549 (W.D. PA 2005)

a. Facts

In what the Court referred to as a case of first impression, a magistrate judge's report held that I.R.C. § 2703(a) applied to a provision in a limited partnership agreement dealing with a transfer of an interest in the partnership. The provision set out the price and the terms upon which the partnership was required to pay a partner for his or her limited partnership interest if the partnership exercised its right of first refusal. Consequently, if the safe harbor under I.R.C. § 2703(b) did not apply, the provision would be ignored in valuing a limited partnership interest in the partnership. The taxpayers had argued that I.R.C. § 2703 only applied to independent buy-sell agreements, relying on *Church v. U.S.*, 2000-1 USTC ¶60,369 (W.D. Tex. 2000), *aff'd without published opinion*, 268 F.3d 1063 (5th Cir. 2001) and *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000) (*Strangi I*), *aff'd in part and rev'd and remanded in part*, 293 F.3d 279 (5th Cir. 2002). The report distinguished *Church*, because in that case the IRS had argued that state law restrictions on the admission of a transferee as a partner should be ignored, and distinguished *Strangi I*, because in that case the IRS had argued that the entity itself should be ignored. Neither case dealt with restrictions in the limited partnership agreement itself.

b. The Court's Opinion

Although the Court found that the agreement was a bona fide business arrangement because it facilitated maintenance of family ownership and control, the Court denied the taxpayers' motion for summary judgment that all three requirements of the safe harbor under I.R.C. § 2703(b) were satisfied. The Court believed that taxpayers had presented insufficient evidence in the record to allow the Court to determine whether the agreement was not a testamentary device and was comparable to similar arrangements entered into by persons in an arm's length transaction, which are the second and third requirements under the safe harbor.

The Court stated that the determination of whether a restrictive agreement is merely a testamentary device involved an inquiry into the intent of the parties at the inception of the agreement, as well as the transferor's health at the inception of the agreement, significant changes in the business subject to the restrictive agreement, selective enforcement of the restrictive provision and the nature and extent of the negotiations that occurred among the parties regarding the terms of the restrictive provision.

c. Analysis of the Court's Opinion

While the case indicates that satisfying the comparability test may be difficult, most commentators had already noted that the comparability test would be difficult to satisfy, depending upon how the Courts approached it. The Court, citing the regulations, stated the test was met if the right or restriction "conforms with the general practice of unrelated parties under negotiated agreements in the same business." In this case, the Court dismissed the affidavits of two lawyers that the restrictions at issue were common in both family limited partnerships and transactions among unrelated parties as conclusory in nature and not evidence sufficient to dispel any genuine issue of material fact as to whether the restrictions met the test. It is true that buy-sell agreements for closely held businesses are not generally made public. However, using the method contained in a qualified business appraisal prepared at the time the buy-sell agreement is negotiated to establish the formula for determining the purchase price may serve as evidence that the purchase price under the buy-sell agreement is commercially reasonable.

The holding that I.R.C. § 2703(a) applies to restrictions in a partnership agreement is also no surprise to most practitioners. It has been assumed since I.R.C. § 2703 was enacted in 1990 that it was not limited to stand alone buy-sell agreements, but could apply to any restrictions in the entity's operative agreements.

d. Rehearing

The Magistrate on rehearing concluded that it was unnecessary to determine whether the safe harbor under I.R.C. § 2703 was satisfied, because it found that the restriction in the partnership agreement did not satisfy the law before the enactment of § 2703. Specifically, the Magistrate found that the agreement was not binding on the donor because he had the ability under the agreement to amend or modify the agreement as the owner of 2/3 of the general partnership interest and more than 50% of the limited partnership interest. While the Magistrate's conclusion would be correct if the limited partnership interests were being valued in the estate of the donor rather than as gifts made by the donor, the Magistrate's conclusion is not correct for purposes of valuing a gift. In valuing a gift, the fair market value is what a willing buyer would pay to a willing seller for the gifted interest, and in this case a willing buyer of a minority interest, who would not be able to amend or modify the agreement, would take into account restrictions in the agreement in determining what he or she was willing to pay for the interest.

5. ***Estate of Senda v. Commissioner***, 97 AFTR 2d 2006-419 (8th Cir. 2006), *aff'g* T.C. Memo 2004-160

a. Facts

The taxpayers, husband and wife, created two limited partnerships to which they transferred shares of MCI WorldCom stock. They also transferred limited partnership interests in each limited partnership to their three children or trusts for the benefit of their three children. They reported the gifts as gifts of limited partnership interests on their tax return for the years involved, applying combined discounts for lack of control and marketability of 38.82% for gifts of interests in the first partnership and 45% for gifts of interests in the second partnership. The IRS agreed that the discounts were appropriate if the transfers were transfers of partnership interests and not gifts of the shares of stock to the partnerships and, therefore, indirect gifts of the shares to the children. However, the IRS contended in its notice of deficiency that the taxpayers' transfers of the shares to the partnerships were indirect gifts to their children because the taxpayers, under the facts, did not receive increased partnership interests in exchange for the transfers. Consequently, discounts from the value of the shares were not appropriate.

b. The Tax Court's Opinion

The Tax Court, found that the facts in the instant case were similar to the facts in *Shepherd v. Commissioner*, 115 T.C. 376 (2000), *affd* 283 F.3d 1258 (11th Cir. 2002). In both cases, the value of the children's partnership interests was enhanced by their parents' contributions to the partnership. The taxpayers argued that, because their capital accounts were increased by the amount of their contributions, they did not make gifts of the shares to the partnership, citing *Jones v. Commissioner*, 116 T.C. 121 (2001). However, the Tax Court found that there was no reliable evidence that the taxpayers contributed the shares to the partnership before they transferred the partnership interests to the children. In an unfortunate statement, Judge Cohen, who wrote the opinion, stated "[A]t best, the transactions were integrated (as asserted by the [IRS] and, in effect, simultaneous." Note also that Judge Cohen referred to the petitioner's testimony as "evasive."

c. Analysis of the Tax Court's Opinion

Because the facts surrounding the transfers to the partnerships and gifts to the children or trusts for their benefit as described in the opinion are rather vague, it is not surprising that Judge Cohen held that the taxpayers made indirect gifts of the shares to the children, although another judge could have reached the opposite conclusion. Nevertheless, the case is a reminder that formalities are important in achieving the desired tax consequences. When the goal is to gift interests in the entity and not the underlying assets, it should be clear from the documentation and the actions of the parties involved that the underlying assets were transferred to the entity in exchange for interests in the entity, and then the interests in the entity were gifted to the donees. Although it should not matter whether there is any time period between the transfer to the entity and the gift of interests in the entity, as long as it is clear that the transfer to the entity came first and was in exchange for an increased interest in the entity, prudence may dictate waiting a day before making the gifts.

Of interest is the range of discounts the IRS was willing to agree to. There were additional gifts made of interests in the second partnership in the year after it was formed that the IRS agreed were gifts of partnership interests and not indirect gifts. The combined discount for lack of control and lack of marketability allowed for these gifts was 46.13%. In addition, the IRS did not challenge the validity or economic substance of the partnerships.

d. The Court of Appeals' Opinion

The Court of Appeals found that the Tax Court did not clearly err in finding that the Senda's transfers were integrated steps in a single transaction. The Eighth Circuit dismissed the taxpayers' argument that the Tax Court's decision ignored state law that would not disregard the entity. According to the Court of Appeals, although state law creates legal interests and rights, federal law designates what interests or rights will be taxed. It also rejected the taxpayers' argument that the step-transaction doctrine does not apply to gifts. The Court noted that its first case involving the gift tax involved the step-transaction doctrine. Citing one of its earlier decisions, it stated that for purposes of taxation, the concern should be the substance and not the form.

e. Analysis of the Court of Appeals' Opinion

Unfortunately, while the Eighth Circuit's comments with regard to the step-transaction doctrine could be viewed as dicta, practitioners should be placed on notice that the IRS is likely to use these comments to attack transactions where soon after an entity is formed, gifts in the entity are made. If the contribution of property or cash to an entity increases the contributor's interest in the entity under the operative agreement, and the contributor then gives away part of the contributor's interest in the entity, the two steps should not be collapsed, regardless of the lapse of time between the two events.

The step-transaction doctrine should only be applied where the intermediate step is not necessary to accomplish the taxpayer's nontax objective. If the intention of the taxpayer is to transfer a limited partnership or membership interest to a donee, rather than an interest in the asset itself, the intermediate step of forming the entity is a necessary step in accomplishing that objective. Viewing the two steps as an integrated transaction ignores the substance of the transaction, because the donee ends up with an interest in the entity and not an interest in the asset itself.

6. Anderson v. United States, No. 02-2168-S (W.D. LA 2006)

a. Facts and Court's Opinion

This case involved a suit for refund of estate taxes paid resulting from a deficiency notice. The main issue involved the valuation of mineral interests owned by the decedent directly and through four LLCs. At issue were the appropriate discounts and proper valuation methods. An earlier ruling had determined that the proper valuation method was a combination of the net asset approach and the market approach weighting the net asset approach 2 to 1 over the market approach. In addition, a liquidation cost of 10%, a minority discount of 10%, and a lack of marketability discount of 40% were applied to the net asset approach and a 40% lack of marketability was applied to the market approach.

The opinion dealt with the determination of the value under the market approach. The Court was aided by the estate's rebuttal expert, Shannon Pratt, whom the Court characterized as "perhaps the most credentialed of all experts in the field of business valuation." Because Pratt seemed to be unbiased, the Court relied heavily on his analysis. The Court concluded that a combination of price-to-cash flow averages and price-to-appraised worth were the appropriate financial measures for use in evaluating comparable companies and the multiple suggested by one of the estate's experts was the appropriate multiple.

Another issue involved the estate's claim for attorneys' fees and litigation costs. The Court indicated that the estate may not be entitled to the recovery of the fees and costs because the IRS' position may have been substantially justified. However, it did not need to deal with that issue because the value of the estate exceeded the $2,000,000 net worth requirement. The Court rejected the estate's argument that the net worth requirement was unconstitutional, based on *Richard v. Hinson*, 70 F.3d 415 (5th Cir. 1995).

b. Analysis of the Court's Opinion

The case emphasizes the importance of engaging credible experts.

7. Estate of Amlie v. Commissioner, TC Memo 2006-76

a. Facts of the Case

Pearl Amlie (the decedent) had three children, Rod, Thomas, and Rosemary. In her 1978 will she left farm land in equal shares to Rosemary and Thomas, and an amount of bank stock to Rod equal in value to one-half of the value of the farm land, and the balance of her estate in equal shares to her three children. Rod and his family were given the right to purchase any bank stock not passing to them.

In 1988, a conservator was appointed to handle the decedent's affairs. During the conservatorship, there were acrimonious disputes among the decedent's children. Thomas and Rosemary distrusted Rod, whom they blamed for the FDIC's forced closing of one of the banks decedent owned and Rod had managed.

In 1991, the decedent's bank stock was converted to common and preferred stock of Agri-Bank (Agri). The conservator entered into an agreement (the 1991 Agreement) with David Hill, the majority shareholder of Agri providing for restrictions on the transfer of Agri stock and giving the decedent a put option to sell the stock to Agri for book value and Agri a call option to purchase all of decedent's stock at the same price. In addition, if Hill sold his controlling interest to a third party, the decedent would be offered the opportunity to sell her stock to the same party for the same consideration, which included the value of any noncompete, consulting or similar arrangements or payments for the benefit of Hill (referred to as the Hill Rights). Finally, if the prospective third party purchaser of Hill's stock conditioned the purchase on the right to acquire the decedent's stock as well, the decedent was required to sell her stock for the prescribed consideration.

The conservator's reasons for entering into the agreement was to postpone the sale of the bank stock until after the decedent's death in order to eliminate capital gain tax on the unrealized appreciation because of the step-up in basis under I.R.C. § 1014, to protect the decedent's minority status in the event of the sale of the controlling shareholder's stock, and to provide liquidity for the decedent's estate, which included a number of valuable illiquid assets. The agreement was approved by the local county court (the District Court) as being in the decedent's best interest.

In 1994, Hill agreed to sell his stock in Agri, as well as two other banks, to First American Bank Group (FABG) in exchange for FABG stock, based on book value, a five year employment contract, a signing bonus, retirement of certain capital notes held by one of the other banks, and an option to exchange his FABG stock in five years for all of the stock of a subsidiary of FABG. The decedent's shares were also exchanged for FABG stock, again based on book value.

The conservator and FABG entered into an agreement (the 1994 Agreement) to purchase the decedent's FABG stock for approximately $118 per share, 1.25 times the book value at the time of the exchange. The consideration over book value took into account the decedent's Hill Rights. In addition, under the 1994 Agreement, FABG and the decedent were given call and put rights exercisable within 60 days after the notice of the decedent's death at $118 per share. The conservator, by this time Boatmen's Bank of Iowa, had a valuation specialist from Boatmen's Trust Co., a related entity, review the terms of the 1994 agreement. She determined that the $118 per share price was fair for the decedent's FABG stock, including the Hill Rights. The conservator also believed the 1994 Agreement was in the decedent's best interest because the agreement guaranteed a fixed price and buyer for the FABG stock and deferred the sale until after the decedent's death, avoiding capital gain tax. Rod objected to the agreement in the proceedings before the District Court because he believed the Hill Rights were undervalued. Consequently, the District Court did not approve the 1994 Agreement because it found that the $118 price failed to compensate the decedent adequately for the Hill Rights.

In 1995, pursuant to negotiations started by the conservator, the prospective heirs of the decedent (which included the children of Thomas, who had died) reached a settlement, the 1995 Family Settlement Agreement (the "1995 FSA"), that provided that the $118 price for the FABG stock would be used in determining the number of shares required to satisfy Rod's specific bequest under the decedent's will and the price Rod and his family had to pay for the balance of the stock not otherwise passing to them. In addition, the Hill Rights were assigned to Rod's family. Finally, certain legal fees were paid by the conservator out of the decedent's assets, including $30,000 to Rod. The District Court found the 1995 FSA was in the decedent's best interest.

In 1997, Rod's family reached an agreement with FABG (the 1997 Agreement) that required FABG to purchase all of FABG stock Rod's family would receive at the death of the decedent at $217.50 per share. The increased price was due to the increased value of the Hill Rights, particularly the value of the option to exchange FABG stock for all the stock of the subsidiary.

The decedent died on October 18, 1998, at the age of 96. Rod's family exercised its option to buy the balance of FABG stock not passing to them under the decedent's will for $118 a share. FABG then purchased the stock for the agreed price of $217.50 a share, which eventually went to Rod's family.

The IRS, in its notice of deficiency, determined that the value of the FABG stock was $1,489,725, the purchase price paid to Rod's family pursuant to the 1997 agreement, rather than $993,757 that was reported on the estate tax return and that represented the $118 price under the 1995 FSA. In addition, the IRS determined that the underpayment arising from the undervaluation of the FABG stock was attributable to fraud or, in the alternative, negligence or disregard of rules and regulations under I.R.C. § 6662. The IRS also determined that the payment of Rod's legal expenses in connection with the 1995 FSA was a taxable gift. Although the reported value of five parcels of land owned by the decedent was also disputed by the IRS, this discussion only deals with the stock valuation issue.

b. <u>Court's Opinion</u>

After determining that the estate was not entitled to have the burden of proof shifted to the Commissioner under I.R.C. § 7491 because Rod had refused the IRS' agent's request for an interview, the Tax Court turned to the valuation of FABG stock. At the heart of the matter was whether the 1995 FSA was controlling for determining the value of the stock for federal estate tax purposes. In reaching its conclusion that the 1995 FSA did establish the value of the stock, the Tax Court considered the requirements set forth in the regulations and case law, as well as the additional requirements imposed by I.R.C. § 2703.

The Tax Court found that the 1995 FSA satisfied the requirements under the regulations and case law before the enactment of I.R.C. § 2703; namely, that the agreement contained a fixed and determinable price for decedent's FABG stock and that the agreement was enforceable. The IRS had contended that the price was not determinable because it was not certain that Rod's family would have to purchase any of the stock from the estate at the $118 price, since it could have received all of the stock pursuant to the specific bequest. However, the Tax Court viewed the satisfaction of the specific bequest with the stock at the $118 price as a sale or exchange. The Court stated:

> Pursuant to the agreement reached between the conservator and the prospective heirs, the estate could receive no more (and no less) than the $118 price for all shares of decedent's FABG stock, thereby effecting a transfer of the risk of loss or opportunity for gain on the shares from the decedent and her estate to the Rod Amlie Trust.

The Court also found that the 1995 FSA satisfied the three requirements under I.R.C. § 2703; namely, it was a bona fide business arrangement, it was not a device to transfer the stock to members of the decedent's family for less than full and adequate consideration in money or money's worth, and its terms were comparable to similar arrangements entered into by persons in an arm's length transaction. The Court rejected the IRS' argument that the 1995 FSA was not a bona fide business arrangement because the subject of the agreement was not an actively managed business interest but merely an investment asset. In the Court's view, the agreement served a business purpose within the meaning of I.R.C. § 2703(b)(1) because it represented the conservator's efforts to hedge the risk of the decedent's holding of a minority interest in FABG. In addition, planning for future liquidity needs of the decedent's estate, which was also one of the objectives underlying the 1995 FSA, constituted a business purpose under I.R.C. § 2703(b)(1).

The Court also found that the 1995 FSA was not a testamentary device. The conservator, in an effort to fulfill its fiduciary obligations, and the other prospective heirs in furtherance of their own interests, accepted a price they believed (on the basis of professional advice) was fair at the time and in the particular circumstances.

Finally, the 1995 FSA satisfied the comparability test because it was based on the price terms reached in the 1994 Agreement, which was based on a survey of comparables. The fact that Rod was able to secure a price of $217.50 per share from FABG in 1997 was attributable to the increase in the value of the Hill Rights during that period, due to a large degree to the increased value of the subsidiary, which Hill had to right to acquire in exchange for his FABG stock.

c. Analysis of the Court's Opinion

Note that the price paid by FABG for the decedent's stock, $217.50 per share, was almost double the $118.00 pre share value reported on the estate tax return. Under I.R.C. §2703, if the 1995 FSA had been disregarded, the value per share for estate tax purposes would have been $217.50, because that was arguably the fair market value of the share. The sale price of an asset so close to the date of death is usually the best evidence of its value for estate tax purposes. It is only the fact that the Tax Court found that the 1995 FSA was controlling, because it satisfied both the requirements under the regulations and case law before the enactment of I.R.C. § 2703 and the three requirements under I.R.C. § 2703, that allowed the estate to successfully use the $118 per share value.

Is this case a blueprint for creating an artificially low value for an asset that is passing to a family member? It is doubtful that the unique fact situation in this case could be duplicated on purpose without the resulting arrangement being treated as a sham. In this case there were several third parties whose interests were affected by the various agreements that led to the 1995 FSA; namely, David Hill, FABG, and the conservator. In addition there was ample evidence of discord among the children. Finally, the conservator was subject to a fiduciary duty to the decedent, and, presumably, to all her prospective heirs. If the other heirs of the decedent thought that the deal struck by the conservator and the prospective heirs with Rod's family was unfair because of the substantial increase in price Rod was able to get from FABG two years later, they may have had a cause of action against the conservator. Perhaps that is one reason why, as the facts state, the conservator did not personally sign the 1995 FSA, although the District Court approved it.

The case also emphasizes an important aspect of the statutory safe harbor under I.R.C. § 2703, as interpreted by the regulations, that, <u>at the time the right or restriction is created</u>, the terms must be comparable to similar arrangements entered into by persona in an arm's length transaction. Note that the underlined phrase was added to the statutory language by the regulations and was part of a technical correction bill that was never passed. The underlined language makes it clear that, although later unforeseen events may cause the price under the arrangement to be substantially different than the value at the decedent's death, the price under the arrangement will still be controlling if the terms were comparable at the time the arrangement was entered into. However, at the time the agreement was created, various factors must be considered, including the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted. The Court went to great lengths to point out the benefits the conservator sought to achieve in the 1994 Agreement and did achieve in the 1995 FSA, including protecting the decedent's minority position and providing liquidity to her estate. The Court also stressed that it was the unexpected increase in the value of the subsidiary that caused a substantial increase in the value of the Hill Rights, and, consequently, the increased price FABG was willing to pay for the stock. Had it been certain that the Hill Rights would increase in value over a short period of time, the arrangement may not have satisfied the comparability test.

A final point made by the Court is that in certain circumstances an isolated comparable may be sufficient to satisfy the comparability test. The

Commissioner had argued that the fact that the 1995 FSA was based on the 1994 Agreement did not satisfy the test because it was an isolated comparable. The Court rejected this interpretation of the regulations, finding that the statement in the regulations, that isolated comparables are not evidence of general business practice, was more a safe harbor and not an absolute requirement that multiple comparables be shown. Nonetheless, the Court went on to note that, because the valuation specialist did consider merger multiples for all Midwest region banks in determining that the $118.00 per share price was reasonable, multiple comparables were in fact considered.

While not discussed by the Court, the regulatory exception did not apply in this case. Under the regulatory exception, the statutory safe harbor is deemed satisfied if the family owns less than 50% of the value of the property and the non family members are also subject to the same arrangement. Although the decedent's family owned considerably less than 50% of the stock of FABG, the 1995 FSA only applied to the decedent and her prospective heirs. For the regulatory exception to apply, the restrictions must apply to the non family members as well.

8. ***Estate of Rosen v. Commissioner***, TC Memo 2006-115

a. <u>Facts of the Case</u>

Lillie Rosen (the decedent) died in 2000. At her death, her revocable trust owned approximately 35% of the limited partnership interest of the Lillie Rosen Family Limited Partnership ("the partnership"), which was created in 1996. The decedent had transferred approximately $2.4 million dollars in cash and marketable securities to the partnership in exchange for 99% limited partnership interest. Her son and daughter transferred approximately $12,000 each for a .5% general partnership interest. Between 1996 and 2000, the decedent gave to her children, her grandchildren, trusts for the benefit of her great grandchildren, and a daughter-in-law, approximately 64% of her limited partnership interest. The IRS contended that the assets the decedent transferred to the partnership were includable in her estate under I.R.C. §2036(a)(1).

The trust was created after her son-in-law, who is an attorney, attended a seminar on family limited partnerships and concluded from the seminar that the decedent's assets should be transferred to a family limited partnership in order to reduce the value of her estate for federal estate tax purposes. The decedent's estate planning attorney structured and formed the partnership without any discussions with the decedent's children, although he did discuss the matter several times with the son-in-law. Several years before the partnership was formed, the decedent had been diagnosed as unable to manage her affairs.

b. <u>Court's Opinion</u>

The Tax Court first dealt with the bona fide sale for adequate and full consideration exception. It noted that in order to satisfy the exception, the transfer must have been made in good faith, and the price must have been an adequate and full equivalent reducible to a money value. Citing *Estate of*

Bongard v. Commissioner and *Estate of Thompson v. Commissioner*, the transfer of assets to the family limited partnership meets this requirement if the record establishes that (1) the family limited partnership was formed for a legitimate and significant non-tax reason and (2) each transferor received a partnership interest proportionate to the fair market value of the property transferred. To qualify as a "legitimate and significant non-tax reason," the reason must have been an important one that actually motivated the formation of the partnership from a business point of view. The reason must be an actual motivation, not a theoretical justification, for a limited partnership's formation. Citing *Thompson*, the Court stated that the transfer to a family limited partnership is not a bona fide sale if it does not "provide the transferor some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form." The Court found that the overwhelming reason for forming the partnership was to avoid federal estate and gift taxes and that neither the decedent nor her children had any legitimate and significant non-tax reason for the formation.

The Court dismissed the petitioner's assertion that there were four legitimate and significant non-tax purposes for forming the partnership: (1) to protect the decedent's assets during her lifetime, and ultimately, to provide limited liability protection to the donees of the limited partnership interests; (2) to create giftable assets that preserve value and cannot be easily liquidated in the short term; (3) to facilitate the decedent's annual gifting program to her family; and (4) to provide for the common management of the partnership's assets during the decedent's lifetime and after her death.

The Court dismissed all of these reasons. First, the Court was unpersuaded that the decedent's creditors would not have been able to foreclose on substantially all of the decedent's assets transferred to the partnership or would have withstood the scrutiny of a bankruptcy court. The Court also stated that even if facilitating the decedent's gift giving and preserving the value of her gifts were actual reasons for the partnership's formation, it was not a significant non-tax purpose that could characterize the transfer of the decedent's assets to the partnership as a bona fide sale. The Court also found that the decedent's irrevocable trust already provided for the common management of her assets.

The Court listed a number of objective facts that supported its conclusion that the transfer of the decedent's assets to the partnership was not a bona fide sale including:

(1) The FLP was not engaged in a valid, functioning business operation, and served no legitimate or significant non-tax purpose.

(2) The partners of the partnership did not negotiate or set any of the terms of the partnership, and the decedent's daughter as the decedent's attorney-in-fact, co-trustee of the decedent's irrevocable trust, and the general partner of the partnership, stood on all sides of the transaction.

(3) Initial contributions to the partnership were made more than three months after the partnership agreement was signed and the contributions of the decedent's children were de minimis in relation to the assets contributed by the decedent, and were arguably derived from gifts made to them by the decedent.

(4) The decedent, acting through her daughter, transferred substantially all of her assets, including all of her investment assets to the partnership. The management of the transferred assets was the same both before and after the transfer, and no meaningful change occurred in the decedent's relationship to her assets after the transfer.

(5) After the transfer of the assets to the partnership, the decedent was unable to meet her financial obligations without using the funds of the partnership.

(6) The assets that were contributed to the partnership consisted solely of marketable securities and cash. The Court noted that the mere holding of a untraded portfolio of marketable securities weighs against the finding of a non-tax benefit for a transfer of that portfolio to a partnership.

(7) The decedent was 88 years old and in failing health.

Because the first prong of the bona fide sale exception was not met, the Court did not have to deal with the second prong, that each transferor received a partnership interest proportionate to the fair market value of the property transferred.

The Court then turned to whether the decedent retained the possession or enjoyment of the transferred property. The Court found that it was understood that the decedent would receive distributions when and as she needed them, noting the following factors:

(1) The partnership was not a business operated for profit, but a testamentary device whose goal was to reduce the estate tax value of the decedent's assets. After the transfer, the partnership used the assets received from the decedent to pay indirectly the same types of expenses and conduct the same gift giving as before the transfer.

(2) The decedent's relationship to her assets did not change following the transfer to the partnership. The funds of the partnership were used to pay the decedent's living expenses, to make gifts to her descendents, and after her death, to pay the bequests under her revocable trust and the expenses of her estate, including, five years after her death, her estate taxes. No funds of the partnership were ever distributed to any of the other partners.

(3) The decedent's assets were transferred to the partnership on the advice of counsel in order to minimize the tax on the passage of her estate to her descendents.

The taxpayers asserted that the distributions from the partnership to the decedent were actually loans that did not constitute enjoyment of the underlying funds. The Court analyzed the following factors used to distinguish debt from equity:

(1) The name given to an instrument underlying the transfer of funds;

(2) The presence or absence of a fixed maturity date and a schedule of payments;

(3) The presence or absence of a fixed interest rate and actual interest payments;

(4) The source of repayment;

(5) The adequacy or inadequacy of capitalization;

(6) The identity of interest between creditors and equity holders;

(7) Security for the repayment;

(8) The transferee's ability to obtain financing from outside lending institutions;

(9) The extent to which repayment was subordinated to the claims of outside creditors;

(10) The extent to which transferred funds were used to acquire capital assets; and

(11) The presence or absence of a sinking fund to provide repayment.

While some of the factors the Court deemed not relevant, it found that the economic realities required that the decedent's use of the funds of the partnership be characterized as distributions to the decedent.

Finally, the Court rejected the taxpayer's argument that the transfers of interests in the partnership more than three years before the decedent's death were not includable in her estate under I.R.C. § 2035(a), because the decedent continued to possess and enjoy the transferred assets up until her death.

c. <u>Analysis of the Court's Opinion</u>

While the result in this case is not surprising, it does present a detailed analysis of the bona fide sale prong of the exception to I.R.C. § 2036(a). It should also be noted that, as in many other cases, the same factors that indicate a lack of a bona fide sale also serve to demonstrate that the transferor retained the enjoyment of the income or the property. It also confirms the factors that should be considered in ensuring that intrafamily loans will be respected as loans and not as actual transfers. Finally, this is yet another IRS victory where the entity was formed after the decedent was incompetent and where the advisor, presumably trying to achieve the greatest reduction in the value of the decedent's assets, advised that substantially all of the decedent's assets be transferred to the partnership.

9. ***Temple v. U.S.***, Case No. 97 AFTR 2d 2006-1649 (USDC, E.D. Tex. 2006)

a. Facts of the Case

This case involves gifts made by Arthur and his wife, Lottie (who died before the trial was decided). The gifts involved interests in four entities, a limited partnership that owned and operated a ranch in south Texas; a limited liability company ("LLC") that owned and operated a winery in Napa County, California, and two limited partnerships, one that held stock in Temple-Inland and one that held stock in Time Warner, both of which were publicly traded companies. The issue was the appropriate discounts that were to be applied to the net asset value of the various entities. One of the gifts involved a 76.6% interest in the LLC. The operating agreement for the LLC provided that the company would be dissolved upon the vote of members holding at least 51% of the membership interests. Consequently, the gift of the 76.6% interest enabled the donee to cause a dissolution of the entity.

b. Court's Opinion

The Court applied the 38% discount to the net asset value of the limited partnership that owned and operated the ranch. The Court rejected the conclusions of the taxpayers' expert because her holding period and distribution assumptions were not based on the actual facts, according to the Court, and she failed to tie the discount for expected appreciation to actual market conditions. In addition, the Court did not find that a discount for potential unrealized capital gains was applicable because I.R.C. § 754 allowed a buyer to increase its basis in the partnership assets and it would be reasonable to expect an economically rational partnership and buyer to negotiate an I.R.C. § 754 election into the partnership acquisition.

With regard to the LLC that owned and operated the winery, the Court rejected the IRS' denial of any discount for lack of control because the 76.6% interest allowed the donee to dissolve the partnership. The Court determined that under California LLC statute, it was not mandated that the assets be sold upon a dissolution. Consequently, the 76.6% owner could become a tenant-in-common with the other owners upon a dissolution of the LLC. The Court noted that, because of zoning requirements, the property could only be divided into two tracts, and that the property contained three types of land with values varying from $800 an acre to $8500 an acre, mountainous land, pasture land, and vineyards. Consequently, a partition would have been extremely difficult to accomplish. The Court also did not find that the donee's listing of her interest on bank loan documents at the net asset value, rather than a discounted value, prevented the donor from taking a discount. Finally, the Court again held that there was no discount for built-in gains because of the availability of the I.R.C. § 754 election.

With regard to the limited partnerships that held the marketable securities, the Court, citing a number of cases, held that the proper analogy was with a closed-end mutual fund. It adopted the discounts offered by the IRS' expert because he analyzed the data from the restricted stock studies and related it to the gifted interests. The IRS' expert based the lack of marketability discount of 12.5% on the following factors: (1) restricted stock studies, (2) academic research, (3) the costs of going public, (4) secondary market transactions, (5) asset liquidity, (6) partnership interest transferability, and (7) whether distributions were made. The discounts for lack of control ranged from 3.3% to 10.1%, depending on the date the gifts were made. The Court again rejected any discount for built-in gains because of the availability of the I.R.C. § 754 election, particularly because of the relatively few types of assets held by each of the partnerships.

c. Analysis of the Court's Opinion

It is somewhat surprising that the Court arrived at a discount for the 76.6% interest in the LLC (60%) that was higher than the discount the taxpayer had used in valuing the gifts (58.75%). The opinion also emphasizes the importance of experts relating their methods to the specific facts of the case.

10. ***Huber v. Commissioner***, TC Memo 2006-96

a. Facts of the Case

This case involves gifts of stock in a privately held company during the period from 1997 to 2000 by five (5) shareholders of J.M. Huber Corp. ("Huber"). While the IRS agreed with the taxpayers' freely traded values of the Huber shares, it took issue with the appropriate discount for lack of marketability, based on a report by its expert. The taxpayers, based on a valuation report prepared yearly by Ernst & Young (the "E&Y value"), applied a 50% discount, while the IRS' expert applied discounts ranging from 25% to 45% for the years in question.

From 1994 to 2000, there were approximately 90 transactions of Huber shares between shareholders. The shareholders were not obligated to use the E&Y value to sell their shares. The relationships between buyers and sellers varied. Some were as close as between parents and children or grandparents and grandchildren. Others were as distant as between a trust and a spouse of a second cousin. Other transactions involved nonprofit organizations that sold shares to Huber family members. Each of these sales occurred at the E&Y value. The facts include a detailed discussion of the sale of Huber shares by an estate and by a trust, both at the E&Y value.

b. Court's Opinion

The IRS rejected these sales as establishing the fair market value because they were not at arm's length. The Court analyzed the Huber family relationships, the presence or lack of compulsion on the part of the seller, the reasonableness of the shareholders' reliance on the E&Y value, and the intent of the parties with respect to the sales. The Court concluded that the existence of close family relationship between parties of some of the 90 sales transactions was neutralized by the fact that many of the transactions took place between parties that were hardly related or were unrelated and who had fiduciary obligations to obtain the best price. The Court viewed the variety of relationships among the shareholders in Huber as a positive indicator of the existence of arm's-length sales. The Court also determined that the Brown Estate and Foster Trust were not compelled to sell the shares at the E&Y value. The Court rejected the IRS' argument that the Huber shareholders, because they could not offer their shares to the public, were unable to obtain the optimum price for their shares. First, the Court did not believe that almost 250 shareholders would harmoniously accept an artificially low valuation of the Huber stock so that a few people who may or may not be related to them could pay less estate tax. Second, there was no basis for suggesting that the shareholders would have obtained a higher price if the shares were not restricted.

The Court, citing *Kimbell*, rejected the IRS' argument that the lack of negotiations among the parties connoted a lack of intent to realize the best price for the shares. In addition, the Court rejected the notion that the company had to go public in order for its shareholders to sell their shares at fair market value. According to the Court, shareholders had a right to keep a company privately owned.

c. Analysis of the Court's Opinion

This case confirms that credible sales near the time of a gift or death will establish the value for transfer tax purposes even if the sales were among family members, unless the facts indicate the sales were not at arm's length.

11. ***McCord v. Commissioner,*** 98 AFTR 2d 2006-6147 (5th Cir. 2006*), rev'g* ***C.T. McCord, Jr.***, 120 T.C. 358 (2003).

a. Facts

Mr. and Mrs. McCord, their four sons, and a partnership owned by their four sons formed a Texas limited partnership (MIL) on June 30, 1995. The sons were the only general partners. Mr. and Mrs. McCord held Class A limited partnership interests and each contributed $6,147,182 worth of assets for a 41.16684918% Class B limited partnership interest. The sons' partnership contributed assets worth $2,478,000 for a 16.5948096% Class B limited partnership interest. The assets transferred to MIL had a value of $14,952,384 on the date of transfer. 65% of the assets were marketable securities, 30% were interests in real estate limited partnerships, and 5% were direct real estate holdings, interests in oil and gas partnerships, and other oil and gas interests.

At all times, the Class A limited partners were entitled to receive $20,000 in exchange for their partnership interest but were not entitled to a partnership percentage, and for purposes of the decision it was assumed that the value of the Class A interest was $20,000. The partnership agreement was amended effective November 1, 1995 to give the partnership a call right with respect to an assignee interest held by a charitable donee. On November 20, 1995, Mr. and Mrs. McCord assigned their Class A limited partnership interests to Southern School Foundation, which was then admitted as a Class A limited partner. On January 12, 1996, Mr. and Mrs. McCord assigned their Class B limited partnership interests (approximately 82% of the partnership interests) pursuant to an

Assignment Agreement, which provided that their sons and trusts for the benefit of their sons and their descendants (the GST trusts) were to receive Class B limited partnership interests having a value not in excess of $6,910,933, plus the gift tax and estate tax the donees agreed to pay, the Shreveport Symphony was to receive any Class B limited partnership interest in excess of that amount, up to a maximum value of $134,000, and the balance was to go to the Communities Foundation of Texas, Inc. (CFT). The Assignment Agreement required the assignees to allocate the gifted interests among themselves, based on the fair market value of the 82% Class B limited partnership interest as of the valuation date. In March, 1996, the assignees executed a Confirmation Agreement allocating the gifted interests among the assignees. The net asset value of MIL on the valuation date was $17,673,760. On June 26, 1996, MIL redeemed the interests held by the Symphony and CFT pursuant to a call right. On the gift tax returns filed for Mr. and Mrs. McCord, the value of their gifts to their sons and trusts for their sons was reported at $2,475,096 and $2,482,605, respectively. The gifts were net gifts, and, in addition to the gift taxes payable by the donees, the value of the gifts was further reduced by the obligation of the sons to pay for any additional estate tax payable if either or both of their parents died within three years of the gift. The IRS determined deficiencies based on an understatement of value and the reduction in the value of the gifts because of the sons' contingent obligation to pay any estate tax.

b. Tax Court's Opinion

The issues before the Court were (1) whether the gifted interests were limited partnership interests or assignee interests, (2) the fair market value of the gifted interests, (3) the amount of the gift to CFT, and (4) whether there should be a reduction in the value of the gifts because of the contingent obligation of the sons to pay any estate taxes.

The Court determined that based on Texas law, the MIL Limited Partnership Agreement, and the Assignment Agreement, the gifted interests were assignee interests. The IRS and taxpayers agreed that if the interests were assignee interests, the value would be lower than if they were full limited partnership interests. Note that Judge Swift argued in a concurring opinion that any charitable deduction should have been denied because the donors did not transfer all of their rights as Class B partners and thus the gifts were split-interest gifts that did not qualify under any exception to the general rule that split-interest gifts are not deductible.

The Court then turned to the value of the transferred interests. In determining the lack-of-control discount, the taxpayers' expert and the IRS' expert both agreed that the discount should equal the weighted average of minority interest discount factors determined for each type of investment held by MIL: equities, municipal bonds, real estate interests, and oil and gas interests. The Court held that a 15% discount was appropriate, which was between the 22% advocated by the taxpayers' expert and the 8.34% advocated by the IRS' expert. As to the lack-of-marketability discount, the taxpayers' expert advocated a 35% discount, while the IRS' expert advocated a 7% discount. The Court held that a 20% discount was appropriate, based on the IRS' expert's reliance on private placement studies.

In the most surprising part of Judge Halpern's majority opinion, the Court found that the value of the interest given to CFT should be based on the percentage allocated to CFT by the Confirmation Agreement, but using the value of the 82% limited partnership interest as redetermined by the Court. In other words, the Court multiplied the interest allocated to CFT under the Confirmation Agreement, which was 3.62376573%, by the fair market value of the 82% limited partnership interest as determined by the Court, taking into account the 15% lack-of-control and 20% lack-of-marketability discounts. The Tax Court ignored the IRS' public policy arguments and used a method for determining value that neither party had raised. The Court ruled that the Assignment Agreement had used the term "fair market value" for determining the relative interests that each of the assignees was to receive and not "fair market value as finally determined for federal gift tax purposes" and therefore the allocation determined by the assignees pursuant to the Confirmation Agreement was fixed for determining the value for gift tax purposes. Judges Wells, Cohen, Swift, Gerber, Colvin, Gale, and Thornton agreed with Judge Halpern's opinion.

As previously mentioned, Judge Swift, while concurring, held that the charitable deduction should be denied as a split-interest gift. Judges Chiechi and Foley dissented with respect to the majority's holding as to the amount of the gift to CFT. They believed that the gifts were complete on January 12, 1996 and that the Confirmation Agreement several months later had no bearing on the fact that the gifts to the children, the trusts for the benefit of the children, and the Symphony were fixed dollar amounts and should not be subject to change. Any additional value found by the Court should have been included in the amount gifted to CFT. Interestingly, the majority did state that had the Assignment Agreement used the term "fair market value as finally determined for federal gift tax purposes" instead of simply "fair market value," the result might have been different. Judge Laro dissented. He believed that the value of the gift to CFT should have been the amount assigned under the Confirmation Agreement.

Finally, the Court rejected the taxpayer's contention that the value of the gift should be reduced by the estate taxes that the sons agreed to pay if either or both their parents died within three years of the gift. First, the liability was too speculative according to the Court. The estate tax rates could be changed or the estate tax could be repealed. Second, the rationale for reducing the value of the gift by the gift tax the donees agreed to pay is based on the "estate depletion" theory of gift tax. If the donee pays the gift tax, an obligation imposed on the donor, the donor's estate is benefited. Here there is no benefit to the donor's estate if the donee pays any potential estate tax under I.R.C. § 2035(b). Instead, the benefit goes to the beneficiaries of the estate, unless the obligation to pay the estate tax is treated as an asset of the estate, and therefore causes an increase in the estate tax.

c. Analysis of the Tax Court's Opinion

Unfortunately, the majority failed to take the opportunity to dispose of the defined valuation formula issue one way or another. By basing its opinion on distinguishing "fair market value" from "fair market value as finally determined for federal estate tax purposes," the Tax Court did not discourage practitioners from using a defined valuation formula. As noted earlier, the majority did state that they might have reached a different result if the Assignment Agreement had used the term "fair market value as finally determined for federal gift tax purposes" instead of "fair market value." Judges Chiechi and Foley would have held that the formula clause did not violate public policy and should have operated to shift all the increase in the value of the transferred 82% limited partnership interest to CFT, a charitable organization, thereby eliminating any additional gift tax. As Judge Foley points out, the majority avoided using the substance over form, violation of public policy, or realistic possibility of receipt doctrines as support for their holding.

The holding with respect to the nature of the interest transferred is not surprising, because the parties properly documented the fact that the assignees were not being admitted as limited partners. However, it would seem that any diminution in the value of the interests transferred would be treated as additional taxable gifts under I.R.C. § 2704(a). Also, the Court's rejection of the taxpayers' reduction in the value of the gifts because of their sons' contingent liability to pay any estate taxes seems appropriate, given the fact that any estate tax payable by the estate would have been included in the parents' transfer tax bases, whereas any gift tax payable would reduce their tax bases, unless of course either or both die within three years of the transfer. Finally, the Court's analysis of the lack-of-marketability and lack-of-control discounts appears to be well balanced.

d. Fifth Circuit's Opinion

At the outset, the Fifth Circuit noted that the parties had stipulated that the Commissioner had the burden of proof. In addition, the Fifth Circuit held that its review of the Tax Court's method for determining the value of the gifts and whether the contingent liability for estate taxes if either or both parents died within three years of the gift was de novo because both issues involved mixed questions of law and fact.

In its brief, the Commissioner did not raise the doctrines of form-over-substance, violation of public policy, and reasonable probability of receipt that it had raised at the Tax Court and that were ignored by the Tax Court's majority opinion, although it did request the Fifth Circuit in a footnote to remand the case to the Tax Court to consider the public policy issue if the Fifth Circuit disagreed with the Tax Court's method of determining the value of the gifts. Instead, it relied on the Tax Court's method for determining the value of the gifts. Consequently, the Fifth Circuit held that the Commissioner had waived those arguments. In addition, because the Commissioner did not challenge the Tax Court's holding concerning the assignee issue, the Fifth Circuit held that the Commissioner had also waived that issue. The Fifth Circuit did indicate that it did not necessarily agree or disagree with the Tax Court on that point.

The Fifth Circuit next dealt with the Tax Court's finding as to the value of the gifts. It found the Tax Court's reliance on the Confirmation Agreement for determining the amount of the gifts to be reversible error because it relied on post-gift events. The value of a gift is determined at the date of the gift and cannot be affected by later events. The Tax Court had arrived at its own value for the gifted limited partnership interest and then applied the percentages agreed to by the donees in the Confirmation Agreement, two months after the gifts, to determine the value of the gifts to the GST trusts, the sons, and the charitable donees. The Tax Court ignored the plain language in the Assignment Agreement that gave a specific dollar amount of limited partnership interests to each of the donees except CFT. The Tax Court determined that the defined value formula was not effective for establishing the value because it did not refer to the values as finally determined for gift tax purposes. Although the Fifth Circuit stated that the values determined by all three parties, the taxpayers, the IRS, and the Tax Court, were irrelevant because of the defined value formula, it nonetheless went on to hold that the values determined by the taxpayers' expert were the correct values by default.

The Fifth Circuit's characterization of the events surrounding the adoption of the Confirmation Agreement by the donees is important in understanding its willingness to accept the defined value formula on its face.

> The Taxpayers, who two months earlier had divested themselves of all interest in MIL, were not parties to the Confirmation Agreement or otherwise involved in it. Neither did the Assignment Agreement "call for," i.e., either expressly or impliedly, specify any method or manner that the donees must or were expected to employ in determining how to equate their respective dollar-amount gifts to percentages of interest in MIL. Moreover, each donee was represented by independent counsel and each had the express right to review the Frazier appraisal before entering into the Confirmation Agreement. In addition, any exempt donee that might question or disagree with the Frazier appraisal had the right to retain its own appraiser and, if not satisfied, to resolve questions of value and allocation of interests in MIL through binding arbitration.

The Court went on to state:

> Neither the Majority Opinion nor any of the four other opinions filed in the Tax Court found evidence of any agreement—not so much as an implicit, 'wink-wink" understanding—between the Taxpayers and any of the donees to the effect that any exempt

donee was expected to, or in fact would, accept a percentage interest in MIL with a value less then the full dollar amount the Taxpayers had given to such a donee two months earlier.

With regard to the liability for the payment of any estate taxes incurred by the parents' estates if either or both parents died within three years of the gift (Mr. McCord did die within the three-year period), the Fifth Circuit found that the calculation of the liability was not too speculative. It analyzed factors that were not totally predictable or quantifiable, including the amount of taxes owed by the parents for the gifts, whether there would be an estate tax, whether the three-year rule would apply, whether there would be an estate tax at the death of the parents and what would be the marginal estate tax rate, whether I.R.C. § 3035 or its equivalent would be in effect at the death of the parents, whether the interest rate for determining what a willing buyer and willing seller would agree to use would be the same, and what were the actuarial odds that one or both parents would die within the three-year period. The Fifth Circuit basically held that a willing buyer would base its decision on the facts, as they existed at the time of the gift, including the interest and tax rates and the continued existence of the estate tax and I.R.C. § 3035. It concluded that the three-year limitation of the parents' exposure to additional taxes was sufficiently determinative at the date of the gift to be taken into account.

e. Analysis of Fifth Circuit's Opinion

Does the Fifth Circuit's holding mean that it is safe to rely on a defined value formula to avoid gift or estate taxes? Such a formula may not be challenged by a court in the Fifth Circuit provided the facts are on all fours with the facts in *McCord*, where there was apparently a qualified appraisal; there was no collusion among the donors, the noncharitable donees, and the charitable donees; there was no participation by the donors in the post-gift negotiation among the donees in determining what percentage of the limited partnership interest each was entitled to as a result of the Assignment Agreement; the donees did not retain any interest in the partnership and would not receive any interest back if the values used for reporting the gifts were held to be incorrect; and the charitable donees were represented by counsel and could have engaged an appraiser to assist them in determining that the Confirmation Agreement and subsequent redemption of their interests was fair. Because the Fifth Circuit did not deal with the public policy issues, it would not be difficult for another Circuit, in the proper case, assuming the Commissioner makes a credible argument, to find that a defined value formula is a violation of public policy. There is language in the Fifth Circuit's opinion, however, the indicates that it would not find that a defined value formula violates public policy absent other facts, such as an inadequate appraisal.

The defined value formula should work with regard to a disposition at death when there has been no collusion among the beneficiaries of the estate. Marital deduction formulas have been accepted by the Commissioner since the advent of the marital deduction in 1948. Of course in the case of the estate tax, there is a greater likelihood that the IRS will audit the return and that the issue will be resolved within a relatively short period of time.

In determining the amount of a gift, a defined value formula should not be invalidated where the facts indicate that the donor attempted to arrive at a fair market value through a qualified appraisal, but did not want to incur any gift tax. If the facts surrounding the gift indicate that a defined value formula was used to discourage the IRS from auditing the return, then the defined value formula should not work. In many, if not most, cases a donor wants to give a specific percentage of an interest in an entity or other property rather than a fixed dollar amount, and if the formula is then used as a disincentive to the IRS, it should not have any effect on the outcome of the audit. In other words, it should be disregarded in determining the value of the interest passing to the noncharitable donee, assuming that a charity is the residual beneficiary.

Of course, if the residual beneficiary is the donor, the formula is less likely to withstand muster. Furthermore, where the residual beneficiary is a marital deduction trust or a zeroed-out grantor retained annuity trust (GRAT), thereby achieving the same gift tax consequences as where a charity or the donor is the residual beneficiary, the formula may also be disregarded. While the Fifth Circuit is correct that post-gift events should not affect the value of the gift, such events certainly can demonstrate the lack of a bona fide transaction, one that should be ignored for gift tax purposes.

APPENDIX: FLPs AFTER *STRANGI II*

A. The Benefits of Using FLPs and FLLCs

1. Transfer Tax Benefits.

a. Discounts.

(1) Lack of Control.

(2) Lack of marketability.

(3) Others: portfolio mix, capital gain liability.

b. Example.

(1) Client holds $1,000,000 of IBM stock, wishes to give child $100,000 of the stock. If he gives the stock to child or in trust for benefit of child, the value of gift is $100,000.

(2) If client transfers stock to an LLC and gives child a 10% interest, the value of the gift may be less than $100,000 because of discounts.

2. Non-tax benefits.

a. Limited liability for owners – not a real concern if all the assets are passive investments.

b. Provides for the orderly management of the family's business and non-business assets.

c. Assets in entity protected from owner's creditors.

d. Greater diversification.

e. Lower investment and management costs.

f. Easier to transfer interests – simple deed of gift.

g. Having a larger amount to invest may mean better investment opportunities are available.

h. Protect assets from spouses – either at divorce or at death.

i. Educate younger family members concerning investments.

j. Avoid ancillary administration and possibly state inheritance taxes.

k. Could incorporate succession planning – one child named as successor manager.

l. Avoid or discourage disputes by requiring mediation or arbitration and payment of legal fees by losing party.

m. Positioning shares of stock in a company for a public or private offering by having all of the shares held in one entity.

n. Maintain the older family members' investment philosophy.

B. IRS Response

1. Initially, IRS' position was that lack of control discounts were not appropriate in a family controlled entity – *see* Rev. Rul. 81-253, 1981-2 C.B. 187.

2. IRS' position was rejected by the Courts. *See, e.g., Propstra v. United States,* 680 F.2d 1248 (9th Cir. 1982); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982).

3. In 1993, the IRS reversed its position; family control did not affect lack of control discounts. Rev. Rul. 93-12, 1993-1 C.B. 202.

C. IRS Challenges to the Use of Entities to Depress Value

1. Sham transaction.

2. Step transaction.

3. I.R.C. § 2703 – to disregard the entity.

4. I.R.C. § 2703 – to disregard restrictions on transferability and liquidation.

5. I.R.C. § 2704(b) – to disregard applicable restrictions.

6. Gift on formation.

7. Challenge the amount of discount.

D. Courts Reject IRS Challenges

1. Validly formed entity cannot be disregarded.

2. I.R.C. § 2703 applies to restrictions on interests in an entity imposed by agreements, not intended to disregard the entity itself.

3. Restrictions were commercially reasonable and not disregarded under I.R.C. § 2703.

4. Restrictions were not applicable restrictions under I.R.C. § 2704(b).

   a. Only a restriction on the right to cause a liquidation of the entity itself was treated as an applicable restriction by the Tax Court.

   b. If the restriction could not be removed without the consent of an unrelated party, it was not an applicable restriction.

5. There was no gift on formation if the capital accounts of the contributors reflected the fair market value of the property contributed.

6. Courts sustained taxpayer's discounts if experts were credible and appraisals based on the facts in the case and rejected IRS' experts if not credible.

E. IRS Finds New Arrows in its Quiver

1. I.R.C. § 2036(a) reads as follows:

   The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death –

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

2. Under Treas. Reg. § 20.2036-1(a), an interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express, or implied, that the interest or right would be conferred [on the decedent].

3. In contrast, in *U. S. v. Byrum*, 408 U.S. 125 (1972), the Supreme Court held that, in order to fall under I.R.C. § 2036(a)(2), a right had to be legally enforceable and ascertainable.

4. Twelve cases held that the decedent, in connection with transfers of property to an FLP, had retained the right to the income from the transferred assets under an implied agreement, based on the facts in the cases. *Estate of Schauerhamer v. Commissioner*, T.C. Memo 1997-242; *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000); *Estate of Harper v. Commissioner*, T.C. Memo 2002-121; *Estate of Thompson v. Commissioner*, T.C. Memo 2002-246, *aff'd*, *Turner v. Commissioner*, 3d Cir., No. 03-3173, September 1, 2004; *Kimbell v. United States*, 2003-1 USTC ¶ 60,455 (N.D. Tex. 2002); *Estate of Strangi v. Commissioner*, No. 03-60992 (5th Cir. July 15, 2005), *aff'g* T.C. Memo 2003-145 (*Strangi, II*); *Estate of Ida Abraham v. Commissioner*, 95 AFTR 2d 2005-2591 (lst Cir. May 25, 2005), *aff'g* T.C. Memo 2004-39 (February 18, 2004); *Estate of Lea K. Hillgren*, T.C. Memo, 2004-46; *Estate of Bongard v. Commissioner,* 124 T.C. No. 8 (March 15, 2005); *Estate of Bigelow v. Commissioner*, T.C. Memo 2005-65 (March 30, 2005); *Estate of Edna Korby v. Commissioner*, T.C. Memo. 2005-102 (May 10, 2005); and *Estate of Austin Korby v. Commissioner*, T.C. Memo 2005-103 (May 10, 2005). The *Rosen* case, discussed earlier, is now the 13th such case.

   a. However, the District Court's decision in *Kimbell* was reversed by the Fifth Circuit, which held that the transfer of assets to the limited partnership was a bona fide sale for adequate and full consideration in money or money's worth. *Kimbell v. United States*, 2003-1 USTC ¶ 60,455 (N.D. Tex. 2002).

5. Two of these cases also held that the decedent had retained the right to designate the persons who would possess or enjoy the transferred property

or income from the transferred property. *Kimbell v. United States*, 2003-1 USTC ¶ 60,455 (N.D. Tex. 2002) and *Estate of Strangi v. Commissioner,* T.C. Memo 2003-145 (*Strangi*, *II*).

a. The Fifth Circuit, in reversing the District Court's decision in *Kimbell*, held that the decedent did not retain control over the limited liability company ("LLC") that was the general partner of the limited partnership because she did not control the LLC; she only owned 50% of the membership interest.

b. The Fifth Circuit apparently ignored the following language in I.R.C. § 2036(a)(2): "alone or in conjunction with any person."

6. Four recent cases, *Estate of Schutt v. Commissioner*, T.C. Memo. 2005-126 (May 26, 2005); *Estate of Bongard v. Commissioner*, 124 T.C. No. 8 (March 15, 2005); *Kimbell v. United States*, 371 F.3d 257 (5^{th} Cir. 2004); and *Estate of Stone v. Commissioner,* T.C. Memo 2003-309, held that I.R.C. § 2036(a) did not apply because of the bona fide sale exception.

a. Eleven of the earlier twelve cases involving 2036(a) had held that the exception did not apply, based on a two-prong analysis:

(1) the transfer had to be a bona fide sale, which meant an arm's-length transaction; and

(2) the transfer had to be for an adequate and full consideration in money or money's worth.

b. In *Stone,* the Court found that there was a bona fide sale because the contributors' capital accounts reflected the fair market value of the contributed assets, distributions were based on the relative capital accounts of the partners, and the donee/children actively managed the partnership property after the formation.

c. The Fifth Circuit reversed the Tax Court's decision in *Kimbell v. U.S*, 93 AFTR 2004-2400 (5^{th} Cir. 2004), holding that the bona fide sale exception applied because the decedent received a pro rata partnership interest and the transaction was not a sham or disguised gift.

d. The Tax Court in *Bongard* and *Schutt* also found that the bona fide sale exception applied because in *Bongard* there were business reasons for forming the LLC and in *Schutt* there was a legitimate and substantial nontax reason for forming two business trusts treated as partnerships for tax purposes.

7. *Strangi II* confirmed the holdings in earlier cases concerning when the bona fide sale exception applies and when there is an implied agreement to retain the enjoyment of the income from the transferred assets.

   a. Unfortunately but not surprisingly, the Fifth Circuit did not shed any additional light on when the decedent will be treated as retaining the right to designate the persons who will enjoy the income from the transferred property because the Court found that there was an implied agreement and therefore it did not have to decide whether there was also a retained right to control.

F. Where Do We Stand Today?

1. In light of *Strangi II*, *Schutt, Bongard, Turner/Thompson* and *Kimbell*, FLPs and FLLCs that are properly structured and operated should continue to provide an efficient means of transferring wealth to younger generations; however, it is important to have either a business purpose or a legitimate and substantial nontax purpose for creating the entity if the bona fide sale exception is needed because either I.R.C. § 2036(a)(1) or § 2036(a)(2), or both, apply.

   a. Note that in *Estate of Kelly v. Commissioner*, T.C. Memo 2005-235, the Tax Court applied a 32.24% combined discount for lack of control and lack of marketability to a 94.83% interest in a family limited partnership and a one-third interest in the LLC general partner. The decedent transferred $1,101,475 of cash and certificates of deposit to the limited partnership between June 6 and September 13, 1999, and died on December 8, 1999. He was apparently in good health at the time of the transfers and had railroad retirement income to support him. The IRS dropped its § 2036(a) argument before trial. The IRS had argued for a 25.2% combined discount and the estate had argued for a 53.5% combined discount.

2. The implied agreement argument under I.R.C. § 2036(a)(1) can be avoided by:

   a. refraining from making non-pro rata distributions to the owners, especially the transferor;

   b. refraining from commingling the entity's funds with personal funds;

   c. keeping accurate books reflecting the operative agreement and the entity's operations, beginning as soon as possible after the entity is formed;

d. encouraging the general partners or managing members to actively manage the assets in the entity;

e. complying with all of the formalities imposed by state law;

f. complying with the operative agreement in every respect or amending the agreement to reflect changes in circumstances;

g. ensuring that assets transferred to the entity are retitled to reflect the new owner;

h. not transferring assets that the transferor will continue to use personally, such as his or her residence; and

i. not transferring so much of the older family member's assets that he or she cannot continue to live in his or her accustomed manner without distributions from the entity in excess of distributions that would be considered normal for the type of assets held by the entity.

3. The transferor should not be treated as possessing a legally enforceable and ascertainable right under I.R.C. § 2036(a)(2) if the following facts exist:

a. The transferor never had the right, either alone or in conjunction with any other person, to designate the persons who will receive the income from the transferred property; or

b. Other owners have more than a *de minimis* interest in the entity and the fiduciary duty of the transferor as the general partner or managing member has not been waived.

(1) Note that the Fifth Circuit in *Strangi II* did not object to the Tax Court's finding that, because pro rata distributions to the corporate general partner (1% of the total) were *de minimis*, they did not prevent Strangi from benefiting from the transferred property.

(2) In addition, the Fifth Circuit rejected the taxpayer's argument that a *de minimis* contribution should not be ignored when considering whether there was a substantial non-tax purpose for creating the entity.

(a) The taxpayer cited the Fifth Circuit's opinion in *Kimbell* for the proposition that there was no requirement that a partner own a minimum percentage for transfers to the partnership to be bona fide.

(b) However, according to the Fifth Circuit, the existence of minimal minority contributions when there is a lack of any actual investments could lead the trier of fact to find that a joint investment objective was unlikely.

4. Based on *Schutt, Bongard, Kimbell* and *Stone,* the bona fide sale exception may apply if:

   a. Capital accounts reflect the fair market value of the contributed property;

   b. Other owners have more than a *de minimis* interest;

   c. There is active management of the assets after the creation and funding of the entity (but see *Schutt*, where the decedent followed a buy and hold investment philosophy); and

   d. There are nontax reasons for the creation and funding of the entity.