ESTATE AND GIFT TAX AUDITS

DRAFTING AND PRACTICAL SUGGESTIONS FOR ULTIMATE SUCCESS

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I. ISSUES INVOLVING FAMILY LIMITED PARTNERSHIPS

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. Fifteen cases have 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); *Estate of Austin Korby v. Commissioner*, T.C. Memo 2005-103 (May 10, 2005); *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115; *Estate of Erickson v. Commissioner*, T.C. Memo, 2007-107 and *Estate of Gore v. Commissioner*, T.C. Memo 2007-169.

   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 (5th 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. Fourteen of the earlier fifteen 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 (5th 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 to retain the enjoyment of the income and therefore it did not have to decide whether there was also a retained right to designate the persons who would enjoy the income.

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.

G. Gift Tax Issues: Annual Exclusion.

1. I.R.C. § 2503(b) allows the annual exclusion only if a gifted interest is a present interest.

   a. At a minimum, the donee of an interest should have the right to assign his or her rights to receive distributions from the entity to a third party after first offering to sell the interest to the other owners at the price offered by the third party. See TAM 9131006.

   b. The general partner or partners or managing member or members should also be subject to a fiduciary duty to the other partners or members. See TAM 9131006 and PLR 9415007.

   c. However, the conservative approach would be to give an owner the right to transfer a full ownership interest after first offering it to the other owners on the same terms and at the same price offered by a third party.

      (1) In TAM 9751003, the IRS ruled that limited partners in a limited partnership did not have a present interest because it was uncertain whether any income would be distributed to them since the general partner's fiduciary duty was obviated by a provision allowing the general partners to retain funds for "any reason whatsoever" and the limited partners could not transfer or assign their interests or withdraw from the partnership or receive a return of capital.

      (2) In *Hackl v. Commissioner*, 118 T.C. No. 14 (2002), the Tax Court upheld the IRS's denial of the annual exclusion where the LLC operating agreement prohibited transfers without the manager's consent and gave the manager complete discretion over distributions. The Court ignored the ability of members to transfer assignee interests freely

and the manager's fiduciary duty to the members. The Seventh Circuit upheld the Tax Court's decision, primarily because of the restrictions on transferability. 2003-2 USTC 60,465.

H. Valuation Issues.

1. Introduction.

a. One of the publicized benefits of using a limited partnership or limited liability company (LLC) to transfer wealth to younger family members is the potential reduction in the value for transfer tax purposes of the assets being transferred because of valuation discounts for lack of control and lack of marketability.

b. For example, if an older family member desires to transfer to a younger family member 10% of his or her IBM stock worth $1,000,000, a direct transfer of the shares to a younger family member or to a trust for his or her benefit would be a taxable gift of $100,000.

c. On the other hand, if the older family member transfers the $1,000,000 worth of IBM stock to an LLC and receives all the LLC interest in exchange and he or she then gives a 10% interest in the LLC to the younger family member, the value of the gift for gift tax purposes may be less than $100,000.

d. How much less will depend on the lack-of-control and lack-of-marketability discounts a business appraiser would attribute to a 10% interest in an LLC owning IBM stock worth $1,000,000.

2. A lack-of-control discount, also referred to as a minority interest discount, is appropriate when valuing an interest in an entity that does not give the holder of the interest the right to decide when distributions of earnings will be made, when the entity will be liquidated, and other issues that affect the financial benefits of ownership in the entity.

a. In an operating business, lack of control may also mean the interest holder will not be assured of being an officer or employee of the entity.

b. In the context of a family limited partnership or LLC, which usually involves passive investments, the lost opportunity to be an employee of the entity may not be financially significant.

3. Until the IRS issued Rev. Rul. 93-12, 1993-1 C.B. 202 in 1993, it had taken the position that a lack-of-control or minority interest discount was not appropriate in valuing an interest in an entity controlled by a family.

a. The courts rejected this position, which was originally set out in Rev. Rul. 81-253, 1981-2 C.B. 187, when challenged by taxpayers. *See, e.g., Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982); *Est. of Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1981); *Est. of Andrews v. Commissioner*, 79 T.C. 938 (1982).

b. In 1987, Congress considered a statutory provision disallowing minority interest discounts when a family controlled the business. *See* H.R. Rep. No. 100-391, at 657 (1987), reprinted in 1987 U.S.C.C.A.N. 2313-378.

(1) Ultimately, legislators chose to enact instead I.R.C. § 2036(c), causing the value of a decedent's gross estate to include the value of property transferred during life by a decedent holding a substantial interest in an enterprise, if such transfer represented a disproportionate share of the potential appreciation in the enterprise. H.R. Rep. No. 100-391, at 661, enacted by Pub. L. No. 100-203, tit. X, § 10,402(a), 101 Stat. 1330-431 (1987).

(2) This anti-estate valuation freeze statute was subsequently replaced in 1990 by the special valuation rules of Chapter 14 (I.R.C. §§ 2701-2704). Pub. L. No. 101-508, tit. XI, §§ 11,601-11,602, 104 Stat. 1388-490 (1990).

c. Although the proposal did not pass, the fact that Congress thought a statutory fix was necessary to eliminate minority discounts in family-controlled entities manifested its apparent belief that without such a statutory provision, minority interest discounts would otherwise be appropriate in family-controlled entities.

4. In Rev. Rul. 93-12, 1993-1 C.B. 202, which involved a gift by a 100% shareholder of a corporation of 20% of his stock to each of his five children, the IRS ruled that the family's control of the entity would not be considered in valuing the 20% interests.

a. After Rev. Rul. 93-12 was issued, numerous articles appeared touting the tremendous transfer tax savings available through the use of family limited partnerships. *See, e.g.*, S. Stacy Eastland, Family Limited Partnerships: Transfer Tax Benefits, 7 Prob. & Prop. 59 (1993); Alan S. Gassman and Matthew J. Schirmer, Real Estate Tax Planning Tips After the Revenue Reconciliation Act of 1993, 39-8 Prac. Law. 17 (1993); John R. Jones, Jr., Family Limited Partnerships Achieve Tax and Nontax Goals, 53 Tax'n for Acct. 33 (1994).

b. The next year, however, the IRS seemed to retract some of what it had given when it ruled in a technical advice memorandum (TAM) that a swing-vote premium was applicable when valuing a block of stock transferred to a family member if the block of stock enabled the transferee to join with another related owner of an interest in the entity to form a majority interest. TAM 9436005 (May 26, 1994).

(1) Under the facts in the TAM, the sole shareholder/taxpayer had transferred a 30% block of stock to each of three children, so that any two of the children could combine to form a majority interest.

(2) The ruling was based on *Estate of Winkler v. Commissioner*, T.C.M. 1989-231, in which the Tax Court found that a 10% block of voting stock had special characteristics that enhanced its value when 40% of the stock was owned by the transferor's family and 50% by members of another family.

c. The IRS began also to challenge lack-of-control and lack-of-marketability discounts in situations involving transfers just before the transferor died, particularly where the transfers were carried out by persons acting in a fiduciary capacity on behalf of the transferor. *Est. of Schauerhamer v. Commissioner*, T.C.M. 1997-242; *see also* TAM 4842003 (July 2, 1998); TAM 9736004 (June 6, 1997); TAM 9735003 (May 8, 1997); TAM 9730004 (Apr. 3, 1997); TAM 9725002 (Mar. 3, 1997); TAM 9723009 (Feb. 24, 1997); TAM 9719006 (Jan. 14, 1997).

d. It is noteworthy that the Clinton administration's tax proposals for its last three fiscal years included a provision that would deny valuation discounts for interests in a family-controlled entity for transfer tax purposes to the extent that the entity held passive investments. The Green Book, Feb. 1998, Department of the Treasury, p. 129; also found in General Explanation of the Administration's Revenue Proposals, Doc. 98-4793 Tax Notes Today 183 (Feb. 3, 1998).

5. A lack-of-marketability discount takes into account the fact that an owner of an interest in a nonpublicly traded entity will have more difficulty than an owner of an interest in a publicly traded entity in finding a willing buyer and, in order to sell the interest, may incur expenses, such as legal, accounting, and syndication fees.

a. The price of shares of publicly traded stock or other publicly traded interests already reflects a lack-of-control discount, but does

not reflect a lack-of-marketability discount because they are sold on a recognized exchange and by definition are marketable.

b. However, there are situations in which publicly traded stock may not be marketable in the hands of a particular holder because of federal or state securities laws or blockage, which would occur if the owner held a substantial amount of the shares of the corporation.

    (1) A business appraiser will often use the resulting reduction in value of such restricted stock that is otherwise publicly traded as a measure of the appropriate lack-of-marketability discount to apply when valuing nonpublicly traded stock.

c. The flip side of a lack-of-control discount is a control- or swing-vote premium.

d. In an operating business, a holder of a majority interest may be able to derive greater financial benefits from the business than a minority owner.

e. However, a majority interest in an entity in which the value of the underlying assets exceeds the value of the entity as a going concern should not be entitled to any premium.

    (1) If the holder of the majority interest caused a liquidation of the entity or his or her interest in the entity, he or she would be entitled to receive no more than his or her pro rata share of the liquidation value of the assets of the entity.

        (a) In this case, the fact that he or she controls the timing of the liquidation of the entity simply eliminates the reason for a discount for lack of control, but does not enhance the value of the interest over its pro rata share of the value of the underlying assets.

    (2) It could be argued that any premium for control should be tempered by the fiduciary duty that the controlling owner may have to the other owners.

    (3) The same analysis applies to an interest that could be treated as representing a swing vote.

        (a) The fact that the holder of such an interest could combine with another owner to gain control of the entity does not put that person in a better position

than a person who owns a majority interest to begin with.

(4) Note also that an owner of a significant percentage of the shares of a corporation may not be able to dispose of the shares in a relatively short period of time, and therefore the value of the shares would be reduced. This is referred to as a blockage discount.

6. The following example illustrates conceptually the difference between the value of an interest in an entity whose going concern value is higher than its liquidation value and an interest in an entity for which the opposite is true:

a. Assume there are two limited partnerships with the same liquidation value: one owns an interest in an office building that has a fair market value of $1,000,000 and the other owns a hardware store that could sell its assets for $1,000,000. The office building produces an annual cash flow of $50,000, after taking into account expenses, including interest and principal payments. The hardware store produces $200,000 a year of cash flow. If an investor is seeking a 10% return on investment, he or she would be willing to pay $50,000 for a 10% interest in the office building, even though 10% of the value of the underlying assets would be $100,000. Absent any right to cause an immediate liquidation of the entity or to redeem his or her interest for a pro rata share of the asset value, the greater liquidation value of the office building is less important than its going concern value to the purchase decision. Of course, the actual price paid will also reflect the investor's expectations regarding the likelihood that the entity would be liquidated, entitling him or her to 10% of the appreciated value of the office building. On the other hand, an investor would not likely pay $200,000 for a 10% interest in the entity operating the hardware store, even though such an amount would generate the desired return based on the store's cash flow. The actual amount the investor would pay would turn on the minority owner's lack of control over liquidation and distribution decisions and the interest's lack of marketability.

7. In most estate planning situations involving real estate and other passive investments, including marketable securities, the value of the underlying assets is usually worth more than the value of the entity as a going concern.

a. Therefore, a restriction on the right of an owner to cause a liquidation of the entity or to have his or her interest redeemed at a price equal to a pro rata share of the value of the entity's assets will

be important in ensuring that the interest is entitled to a lack-of-control discount, assuming the restriction is not disregarded for federal transfer tax purposes.

8. Business Appraisals.

   a. Regardless of the theoretical arguments that can be made for lack-of-control and lack-of-marketability discounts, a professional business appraisal should be obtained in every situation involving planning for transfers of interests in a family-controlled entity.

      (1) It is highly unlikely that the lawyer preparing the operative documents and otherwise advising the family will be a qualified business appraiser.

      (2) In many cases the family's certified public accountant or other financial advisor will also not be a qualified business appraiser.

   b. If the IRS challenges the valuation and there is no business appraisal, the family may be forced to have the value of the interest determined many years after the transfer took place and may be subject to penalties in addition to gift taxes and interest.

   c. Although there can be no guarantee that the appraisal will withstand the scrutiny of a court, obtaining a professional business appraisal will put the family in a better position to defend any challenge by the IRS to the lack-of-control and lack-of-marketability discounts taken.

   d. The latest version of I.R.S. Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, requires the taxpayer to indicate whether a valuation discount has been applied and to provide substantiation for the amount of the discount.

   e. The final regulations regarding the adequate disclosure rules for commencing the running of the statue of limitations on gifts treat an appraisal satisfying the requirements in the regulations as adequate disclosure. Treas. Reg. § 301.6501(c)-1(f)(3).

      (1) Consequently, filing a gift tax return reporting a transfer to an entity and subsequent transfers of interests in the entity to other persons with a qualified appraisal attached to the return should start the gift-tax statute of limitations to run.

   f. In some cases it will be necessary to obtain two appraisals, one for the assets held by the entity, such as real estate, and one to determine the value of an interest in the entity, which will depend

upon a number of factors, including the size of the interest, the operative agreements, and the effect of state law on the rights of an owner.

9. Marketable Securities.

a. Assuming that the entity has been formed properly under state law, a limited partnership (or an LLC taxed as a partnership) should be recognized as a valid entity for transfer tax purposes even though the only assets it holds are marketable securities.

(1) The family partnership rules under I.R.C. § 704(e) may disregard for federal income tax purposes a partnership that is valid under state law if certain criteria are not satisfied.

(2) For transfer tax purposes, however, state law determines the property rights that are being transferred unless a specific provision in the Code mandates a different result. *See, e.g., Commissioner v. Est. of Bosch*, 387 U.S. 456 (1967), *Aquilino v. U.S.*, 363 U.S. 509 (1960), *U.S. v. Bess*, 357 U.S. 51 (1958), *Morgan v. Commissioner*, 309 U.S. 78 (1940).

b. Congress recognized that a partnership owning only marketable securities was valid for federal tax purposes when it amended I.R.C. § 731(c) in 1994 to address the tax treatment of partnership distributions of marketable securities. Pub. L. No. 103-465, tit. VII, § 741(a), 108 Stat. 5006 (1994).

(1) Before its amendment, I.R.C. § 731 generally provided that a partner did not recognize income when he or she received property in kind as a distribution from the partnership; instead, his or her basis in the distributed property was the lower of the partnership's basis for the property or his or her basis in the partnership.

(2) On the other hand, a partner did recognize income if cash was distributed and the cash exceeded his or her basis in the partnership.

(3) Because marketable securities are now treated as cash when distributed to a partner, a partner receiving marketable securities may recognize taxable income when he or she receives marketable securities in a distribution. I.R.C. § 731(c)(1)(A).

(4) Marketable securities will not be treated as cash if the partnership never held any assets other than marketable

securities and other investments, indicating that Congress recognized that a partnership that owned only marketable securities was still a partnership for federal tax purposes. I.R.C. § 731(c)(3)(C)(i). *See also* H.R. Rep. No. 103-826(I), at 446 (1994), reprinted in 1995 U.S.C.C.A.N. 3773. ("It is acknowledged that certain partnerships are formed for the purpose of holding marketable securities for investment or for sale to customers.")

c. In addition, the Code defines a partnership as including a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on. I.R.C. § 761(a).

(1) A partnership holding only marketable securities should qualify as a financial operation.

(2) The Code allows an unincorporated organization to elect out of partnership treatment if the only purpose of the entity is investment and not the active conduct of a business. I.R.C. § 761(a).

(3) Such an election would be unnecessary if an unincorporated organization holding nothing but marketable securities could not be treated as a partnership for federal tax purposes in the first place.

d. *Estate of Winkler v. Commissioner* suggests that the Tax Court may find that a valid partnership exists for tax purposes, regardless of the type of assets it holds. T.C.M. 1997-4.

(1) In *Winkler*, parents and five children purchased lottery tickets from time to time that were placed in a bowl in the family's home.

(2) When a ticket purchased by the mother bore the winning number, the family applied for the winning proceeds as a partnership.

(3) Because state law required that the partnership have a written agreement in order to receive the proceeds, the family went to an attorney to have a written agreement prepared.

(4) The agreement provided that the mother and father were each entitled to 25% of any winning lottery proceeds and that the five children were each entitled to 10%.

(5) The IRS claimed that, because the partnership should be disregarded for transfer tax purposes, the mother made gifts of the lottery proceeds to her children.

(6) The Tax Court held that a partnership existed for federal tax purposes based on an analysis of the facts under the family partnership rules and the broad definition of partnership that appears in I.R.C. § 761(a).

e. Finally, Treasury Department regulations under I.R.C. §§ 701, 704, and 761 include discussion of partnerships that are created solely for investment purposes. *See* Treas. Reg. §§ 1.701-1(a); 1.704-3(a)(3); and 1.761-2(a).

II. GIFT TAX ISSUES OTHER THAN FLPS

A. Annual Exclusion.

1. *Crummey* Powers.

a. The IRS has taken the position that an individual having a right to withdraw must have some other present or vested interest in the trust in order for the grantor to obtain the annual exclusion for the part of the donation that the individual has a right to withdraw. TAM 9731004 (Apr. 21, 1997), TAM 9045002 (July 27, 1990), TAM 8727003 (Mar. 16, 1987).

(1) This position may limit the right of withdrawal to individuals who have a present right to income or principal distributions or to vested remainder beneficiaries.

(2) The right of withdrawal held by other individuals who have only a contingent remainder interest in the trust is often referred to as a naked power.

(3) Despite the IRS's position, however, the right of withdrawal held by contingent beneficiaries has been held to be sufficient to qualify for the annual exclusion. Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991), *acq. in result* 1992-1 C.B. 1, 1993-1 I.R.B. 5, 1996-2 C.B. 1 (legal right to demand payment, not likelihood beneficiary will actually receive present enjoyment of corpus, is correct test); Estate of Kohlsaat v. Commissioner, T.C. Memo 1997-212.

(4) Nevertheless, in two Actions on Decision, AOD 1992-09 (Mar. 23, 1992) and AOD 1996-10 (July 15, 1996), and TAM 9731004 (Apr. 21, 1997) (dated before the decision

in Kohlsaat) and TAM 9628004 (Apr. 1, 1996), the IRS has indicated that it will scrutinize the facts and circumstances of each case to determine whether the right of withdrawal is "illusory."

(a) For example, it is possible even a current income beneficiary or a beneficiary with a vested remainder interest would not be treated as having a present interest if there were a prearranged understanding that the right would not be exercised.

(b) In Kohlsaat, the Tax Court heard testimony indicating that there was no prearranged understanding; the court might have ruled differently if this testimony had not been presented.

(5) The facts in the last TAM issued before the Kohlsaat decision, TAM 9731004, involved eight trusts, each having as its primary beneficiary a child of the donor who was entitled to all the trust income each year and the remaining trust assets at the donor's death. If the child died before the donor, the child's children became the primary beneficiaries, and if there were none or they died before the donor, the donor's other children (or deceased children's children) became primary beneficiaries. All the children and grandchildren, as well as the spouses of the children, who had no other interest in any of the trusts, had withdrawal powers. The IRS ruled that only the primary beneficiary had a present interest with respect to each trust.

(6) In Kohlsaat, there was one trust but separate shares for each of the donor's two children who were the primary beneficiaries. In addition, seven grandchildren, eight great grandchildren and one child's spouse were contingent remainder beneficiaries and were all given withdrawal powers. The court held that the power of withdrawal held by the contingent beneficiaries were present interests because there was no evidence of an understanding that the rights would not be exercised or that the contingent beneficiaries believed they would be penalized, and they received actual notice from the trustees with regard to these rights. Further, the donor intended to benefit the contingent beneficiaries; they were relatives of the donor.

b. A right of withdrawal will not be treated as a present interest if the exercise of other rights or powers created under the trust agreement could impede the beneficiary's right of withdrawal.

(1) For example, a right to appoint the assets in the trust should be subject to a beneficiary's right to withdraw a current donation to the trust.

(2) Also, if the trustee has a discretionary right to distribute income or principal, this discretion should be subject to a beneficiary's right to withdraw.

(a) For instance, principal distributions allowable with respect to a current donation to the trust should not be permitted until after the rights of withdrawal have lapsed.

(b) While such distributions usually are not anticipated, language permitting income and principal distributions during the grantor's lifetime may be necessary to give the beneficiaries a present interest in the trust, although the IRS may not agree that a purely discretionary right to distribute income or principal currently creates a present interest in beneficiaries who are only contingent remainder beneficiaries with withdrawal rights.

2. GST Annual Exclusion.

a. To qualify a post-March 31, 1988 transfer to a trust for the GST annual exclusion:

(1) The trust must have only one current beneficiary;

(2) The trust assets must be includible in the beneficiary's estate if he or she dies before the trust terminates; and

(3) If the trust terminates before the beneficiary dies, the trust assets must be distributable to the beneficiary.

I.R.C. § 2642(c)(2).

b. Consequently, the GST annual exclusion will not apply to transfers to a trust having more than one beneficiary unless each beneficiary is treated as having a separate share.

(1) In most cases, the liquidity and support objectives of the insured will not be satisfied by having a separate trust for each beneficiary who is a skip person (a grandchild or more remote descendant).

3. Section 529 Plans.

a. Determine whether a 529 plan is the best use of the client's annual exclusion amount.

b. Consider setting up multiple 529 accounts, client can always change the beneficiary.

4. Payments to health care providers and educational institutions.

a. Under I.R.C. § 2611(b)(1), a transfer from a trust to pay medical expenses or educational expenses is not a generation skipping transfer.

b. Articles have been written suggesting the creation of trusts designed to use the GST exclusion for medical and educational expenses, sometimes referred to a "HEET Trust" (health, education exclusion trust).

(1) One issue is how much of an interest should the charitable beneficiary have to avoid having the IRS ignore the charitable beneficiary's interest because it was created primarily to avoid or postpone the GST tax.

(2) Another issue is how to avoid the separate share rule if the charitable beneficiary is entitled to a percentage of the income each year.

(a) The final qualified severance regulations would indicate that the separate share rule could apply in this case, even though no election was made to treat charitable beneficiary's interest as a separate share.

(b) Giving the charitable beneficiary the right to a fixed dollar amount should avoid the separate share rule.

B. Statute of Limitations.

1. Filing Gift tax returns when no gift has been made.

a. Reporting Sale Transactions; New Line 12 (e) on 706.

(1) The new Form 706 (dated October 2006) has a new question in Part 4, General Information.

(a) Question 12e asks: "Did decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in question 12a or 12b?"

(b) If the answer is "yes," the EIN number of the "transferred or sold item" must be furnished.

(c) Presumably, this means the EIN number of the partnership, limited liability company, or corporation.

(2) Question 12a asks "Were there in existence at the time of the decedent's death any trusts created by the decedent during his or her lifetime?"

(3) Question 12b asks: "Were there in existence at the time of the decedent's death any trusts not created by the decedent under which the decedent possessed any power, beneficial interest, or trusteeship?"

b. The question could be avoided by terminating the trust before the decedent dies.

(1) The trust would not be described in Question 12a or b, so the answer to Question 12e would be no.

(2) That would seem to work if the client does not care if the trust is terminated during his or her lifetime.

c. This new question on the 706 eliminates one purported reason for not disclosing a sale to a grantor trust on a gift tax return.

(1) Many practitioners advised clients to report such transactions on a gift tax return to start the statute of limitations running.

(2) Others had suggested that the disclosure would invite an audit, and by not disclosing the transaction, it may never be picked up by the IRS.

(a) This amounted to playing the audit lottery.

d. Because of the question, unless the trust is no longer in existence at the death of the transferor or the question is not answered correctly, the transaction will eventually be disclosed at the death of the transferor.

2. Statute of Limitations on Gift Tax Assessment and Valuation

a. Gifts Before August 6, 1997.

(1) For estate tax purposes, in determining the amount of adjusted taxable gifts (which is added to the taxable estate for purposes of determining the estate tax), the value of a gift made before August 6, 1997 may be adjusted at any time, even though the statute of limitations has run on the assessment of a gift tax in connection with the gift.

(2) This rule also applies to adjustments involving issues other than valuation. Treas. Reg. § 20.2001-1(a).

(3) For gift tax purposes, if a gift tax return is filed for a year, an assessment of a gift tax for any gifts made during that year, whether disclosed or not may not be made after the statute of limitations has run. Treas. Reg. § 25.2504-2(a).

(a) This rule only applies to gifts made before January 1, 1997. Treas. Reg. § 301.6501(c)-1.

(b) However, an adjustment in the value of any gifts made before August 6, 1997, whether or not disclosed, may be made in determining the prior taxable gifts of the taxpayer for calculating the gift tax on subsequent gifts unless a gift tax has been paid or assessed for the calendar year in which the transfer occurred. Treas. Reg. § 25.2504-2(a).

(c) In addition, adjustments involving issues other than valuation may be made, whether or not a gift tax has been paid. Treas. Reg. § 25.2504-2(a).

b. Gifts After August 5, 1997.

(1) In determining the amount of a decedent's adjusted taxable gifts for estate tax purposes, a gift made after August 5, 1997 that was adequately disclosed on a gift tax return may not be revalued.

(a) While the proposed regulations limited this rule to adjustments involving valuation, and not adjustments involving other issues, such as whether the gift qualified for the annual exclusion, the final regulations apply this rule to all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law.

Treas. Reg. § 20.2001-1(b).

(2) For gift tax purposes, the value of a gift made after August 5, 1997 may not be adjusted after the statute of limitations has run if the transfer was adequately disclosed on a gift tax return. Treas. Reg. § 25.2504-2(b).

(a) While the proposed regulations limited this rule to adjustments involving valuation, and not adjustments involving other issues, such as whether the gift qualified for the annual exclusion, the final regulations apply this rule to all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law. Treas. Reg. § 25.2504-2(b).

(b) A gift made after December 31, 1996 but before August 6, 1997 is subject to the adequate disclosure requirements relating to the running of the statute of limitations, but is still subject to the rule that the gift can be revalued for determining adjusted taxable gifts even if a gift tax had been paid for a gift reported on a gift tax return for 1997.

(3) The value of a gift is finally determined for gift tax purposes if:

(a) The value is shown on a gift tax return, or on a statement attached to the return, and the IRS does not contest the value before the statute of limitations has run;

(b) The value is specified by the IRS before the statute of limitations has run with respect to the gift and such specified value is not timely contested by the taxpayer;

(c) The value is finally determined by a court of competent jurisdiction; that is, when the court enters a final decision, judgment, decree or other order passing on the valuation that is not subject to appeal; or

(d) The value is determined pursuant to a settlement agreement entered into between the taxpayer and the IRS that is binding on both.

(i) A settlement agreement includes a closing agreement, a compromise agreement, or an agreement entered into in settlement of litigation involving the amount of the taxable gift.

Treas. Reg. § 20.2001-1(c), (d).

3. Disclosure Requirements.

a. A transfer will be adequately disclosed on a gift tax return with respect to a transfer made after December 31, 1996, only if it is reported in a manner adequate to apprise the IRS of the nature of the gift and the basis for the value so reported. Treas. Reg. § 301.6501(c)-1(f)(2).

b. Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed if the return or a statement attached to the return provides the following information:

(1) A description of the transferred property and any consideration received by the transferor;

(2) The identify of, and relationship between, the transferor and the transferee;

(3) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust or a copy of the trust instrument;

(4) A detailed description of the method used to determine the fair market value of property transferred, including:

(a) Any relevant financial data.

(b) A description of any discounts, such as discounts or blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property.

(c) In the case of a transfer of an interest that is actively traded, the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest quoted selling prices on the applicable valuation date.

(d) In the case of a transfer of an interest in an entity (e.g., a corporation or partnership) that is not

actively traded, a description of any discount claimed in valuing the entity or any assets owned by such entity.

(5) If the value of the entity or interests in the entity is properly determined based on the net value of the assets held by the entity, the taxpayer must demonstrate that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets or furnish:

(a) A statement regarding the fair market value of 100% of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity);

(b) The pro rata portion of the entity subject to the transfer; and

(c) The fair market value of the transferred interest as reported on the return.

(6) If the entity that is subject to the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the same information is required for each entity, if the information is relevant and material in determining the value of the interest.

(7) In lieu of the above information an appraisal of the transferred property that meets the following requirements:

(a) The appraisal is prepared by an appraiser who satisfies all the following requirements:

(i) The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

(ii) Because of the appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued; and

(iii) The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee, as defined in I.R.C. § 2032A(e)(2), or any person employed by the donor, the donee, or a member of the family of either; and

(b) The appraisal contains all of the following:

(i) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal;

(ii) A description of the property;

(iii) A description of the appraisal process employed;

(iv) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions;

(v) The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value;

(vi) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions;

(vii) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred; and

(viii) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

(8) A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer.

c. Completed transfers to members of the transferor's family, as defined in I.R.C. § 2032A(e)(2) for purposes of the special valuation rules under I.R.C. § 2032A, that are made in the ordinary course of operating a business are deemed to be adequately disclosed, even if not reported on a gift tax return, if the transfer is properly reported by all parties for income tax purposes.

d. Completed transfers, all or a portion of which are reported as not constituting a transfer by gift (other than a transaction in the ordinary course of business), will be considered adequately disclosed if the same information is provided as is required for a transfer that is treated as a gift, plus an explanation as to why the transfer is not a transfer by gift; except that a description of the method used to determine the value is not specifically required, although providing such information is advisable.

Treas. Reg. § 301.6501(c)-1(f)(2), (3), (4).

e. Adequate disclosure of a transfer that is reported as a completed gift on the gift tax return will start the running of the statute of limitations for assessment of gift tax on the transfer, even if the transfer is ultimately determined to be an incomplete gift.

(1) For example, if an incomplete gift is reported as a completed gift on a gift tax return and is adequately disclosed, the period of assessment of the gift tax will begin running when the return is filed.

(2) On the other hand, if the transfer is reported as an incomplete gift, whether or not adequately disclosed, the period for assessing a gift tax with respect to the transfer will not commence to run even if the transfer is ultimately determined to be a completed gift.

(a) In that situation, the gift tax with respect to the transfer may be assessed at any time, up until three years after the donor files a return reporting the transfer as a completed gift with adequate disclosure.

Treas. Reg. § 301.6501(c)-1(f)(5).

f. If a husband and wife elect split-gift treatment, the disclosure requirements are satisfied for the gift deemed made by the

consenting spouse if the return filed by the donor spouse satisfies the disclosure requirements. Treas. Reg. § 301.6501(c)-1(f)(6).

C. Documentation.

1. State law formalities.

a. Important to observe, not only for tax purposes, but for creditor's rights purposes and other state law issues.

b. While the principal purpose of creating an entity for estate planning purposes may be to reduce transfer and income taxes, such entities do create property rights in the owners of the interests in the entity.

2. Back dating.

a. If the date placed on a document has independent significance for tax and other purposes, the actual date of execution should be used.

b. There is no issue if the only significance of the date is to identify the document or "as of" language is used together with the date of the actual signing,

3. Savings clauses.

a. Savings clauses are generally disfavored by the IRS.

b. Savings clauses cannot be sued to override explicit language in the document that affects the tax consequences.

c. Savings clauses may be used for interpreting ambiguous language.

III. BUY-SELL AGREEMENTS

A. Introduction.

1. The value of an asset for federal estate tax purposes is its fair market value at the time of death.

a. Fair market value is defined as the price a willing buyer would pay a willing seller for the property or interest in property, both with reasonable knowledge of the relevant facts and neither under a compulsion to sell or to buy. Treas. Reg. § 20.2031-1(b).

2. Under the regulations and the case law developed before the adoption of the special valuation rules contained in Chapter 14 (I.R.C. §§ 2701-2704), the purchase price determined under a buy-sell agreement can fix the

value of an interest in a closely held business if the following four requirements are satisfied:

a. The price must either be fixed or determinable pursuant to a formula contained in the agreement.

b. The decedent's estate must be obligated to sell at death at the fixed price.

(1) This can be accomplished either by giving the entity or the other owners an option to buy the deceased owner's interest or by using a mandatory buy-sell arrangement.

c. The transfer restriction must apply during the deceased owner's lifetime. Treas. Reg. § 20.2031-2(h).

(1) At a minimum, the other owners must have a right of first refusal to buy the interest at the fixed or determinable price before the owner can sell the interest to a third party. *Estate of Lionel Weil*, 22 T.C. 1267 (1954).

(2) This requirement may not be satisfied if the owners may transfer their interests to relatives or other owners by gift during life unless the donees become subject to the same restrictions.

d. The agreement must be a bona fide business arrangement and not a device to pass the interest to the natural objects of the deceased owner's bounty without full and adequate consideration in money or money's worth. Treas. Reg. § 20.2031-2(h); Rev. Rul. 59-60, Sec. 8, 1959-1 C.B. 237.

(1) Historically, this requirement was satisfied if the price under the agreement was equal to the fair market value of the interest at the time the agreement was originally executed.

3. In *Rudolph v. U.S.*, 93-1 USTC 60,130 (S.D. Ind. 1993), which dealt with a buy-sell agreement predating the effective date of I.R.C. § 2703, the District Court reviewed the fourth requirement in some detail.

a. In holding that the purchase price under the agreement controlled the estate tax value of the shares in a family-owned business, the court rejected the government's position that, because the price under the agreement was below fair market value, the agreement was a device to transfer the shares to the objects of the decedent's bounty without full and adequate consideration.

b. The court held that "the reasonableness of the price set forth in a restrictive agreement should be evaluated based on the facts in existence at the date the agreement is reached unless intervening circumstances occur."

c. In addition, intent to use the agreement as a testamentary disposition must be present before the agreement is held invalid.

4. The owners may be tempted to set an artificially low price in the buy-sell agreement in an attempt to reduce the federal estate tax of a deceased owner, especially when the owners are related.

a. I.R.C. § 2703 should preclude related parties from depressing the value of an interest in a family-controlled entity through buy-sell agreements.

b. In the case of unrelated owners, who may still succeed in depressing the value of an interest through a buy-sell agreement, the difference between the price of the interest under the agreement and the fair market value of the interest can be made up through the use of group term life insurance under I.R.C. § 79, split-dollar insurance arrangements, and death benefit only plans.

(1) The benefits under these plans may be arranged so that they are not included in the deceased owner's estate, generally through the use of irrevocable trusts in the case of insurance arrangements.

(2) Nevertheless, there are problems with using an artificially low price to reduce the estate tax value of the interest.

(a) The buy-sell agreement may not qualify as a bona fide business arrangement, although under the regulatory exception to I.R.C. § 2703, it is not necessary that the agreement be a bona business arrangement.

(b) Because dispositions during lifetime must be made at the lower price set out in the agreement if the agreement is to be effective for establishing the estate tax value, such a plan may not be acceptable to owners who may wish to sell their interests before death.

(c) As a result of the reduced value of the interest, the estate may fail to qualify under I.R.C. §§ 303 (providing for sale or exchange treatment for certain redemptions), 2032A (special use valuation for real

property used in a farming or other closely held business), 2057 (deduction for qualified family-owned business interests, repealed for decedents dying after 2003), and 6166 (installment payments for the estate tax on the value of the estate attributable to closely held business interests).

B. The Impact of Chapter 14 on Valuation.

1. I.R.C. § 2703, added by RRA 90, has a direct impact on the effectiveness of a buy-sell agreement in establishing the value of an interest in family-controlled partnerships and corporations for estate tax purposes.

a. Although it could be argued that I.R.C. § 2703 does not change existing law in a significant way, the new provision makes it clear that the fourth requirement discussed above, *i.e.*, that the agreement must be a bona fide business arrangement and not a device to pass the interest to the natural objects of the deceased owner's bounty without full and adequate consideration, consists of two separate requirements.

b. Consequently, merely because an agreement is a bona fide business arrangement does not mean that it will establish the value for estate tax purposes unless the agreement is also not a device to pass stock or a partnership interest to the natural objects of the deceased owner's bounty without full and adequate consideration.

c. In addition, I.R.C. § 2703 adds a third requirement: the terms of the buy-sell agreement must be comparable to similar arrangements entered into in an arm's length transaction.

2. The general rule under I.R.C. § 2703 is that, for purposes of estate, gift, and generation-skipping transfer taxes, the value of any property is determined without regard to any right or restriction relating to the property. I.R.C. § 2703(a); Treas. Reg. § 25.2703-1(a).

3. A right or restriction means:

a. Any option, agreement, or other right to acquire or use the property at a price less than its fair market value (determined without regard to the option, agreement or right); or

b. Any restriction on the right to sell or use such property. Treas. Reg. § 25.2703-1(a)(2).

(1) A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, shareholders' agreement, or any other agreement. A right

or restriction may be implicit in the capital structure of the entity. Treas. Reg. § 25.2703-1(a)(3).

4. A lease will be disregarded in valuing property for federal gift, estate and generation-skipping transfer tax purposes if the terms are not comparable to leases of similar property entered into among unrelated parties. Treas. Reg. § 25.2703-1(d), Example 1.

5. A perpetual restriction on the use of real property that qualified for a charitable deduction under either I.R.C. § 2522(d) or 2055(f) is not treated as a right or restriction. Treas. Reg. § 25.2703-1(a)(4).

C. Exceptions.

1. Statutory exception.

a. A right or restriction will not be disregarded if it satisfies the following three requirements:

(1) It is a bona fide business arrangement;

(2) It is not a device to transfer the property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

I.R.C. § 2703(b).

b. The regulations make two changes to the statutory language.

(1) In the regulations, the second requirement refers to "natural objects of the transferor's bounty" rather than "members of the decedent's family." Treas. Reg. § 25.2703-1(b)(1)(ii).

(a) Thus the regulations make it clear that I.R.C. § 2703 applies for gift tax purposes as well as estate tax purposes and expands the definition of members of the transferor's family to include objects of the transferor's bounty.

(b) The Technical Corrections Bill, § 102(f)(12), would have codified the change in the second requirement from members of the decedent's family to the natural objects of the transferor's bounty; however, the change was not part of the technical corrections provision in the Small Business Act of 1996.

(c) In the preamble to the final regulations, the IRS explained that it omitted a definition of the term "natural objects of the transferor's bounty" because the concept had long been part of the transfer tax system and could not be reduced to a simple formula or specific classes of relationship, and would not be limited to persons related by blood or marriage.

(d) In *Estate of Gloeckner v. Commissioner*, 152 F.3d 208 (2nd Cir. 1998), the 2nd Circuit reversed the Tax Court's decision that the price under a buy-sell agreement did not establish the value for estate tax purposes, concluding that an employee was not an object of the decedent's bounty, despite being named a beneficiary in his will and receiving several loans from the decedent during the decedent's lifetime, one interest-free.

(i) The case was decided based on pre-Chapter 14 law.

(2) The regulations add "at the time the right or restriction is created" to the third requirement, making it clear that the terms of the agreement are compared with similar agreements at the time the agreement is entered into, not when any rights conferred by the agreement are exercised, such as at the death of the transferor. Treas. Reg. § 25.2703-1(b)(1)(iii).

c. Each of the three requirements must be independently satisfied for a right or restriction to meet the exception.

(1) The mere showing that a right or restriction is a bona fide business arrangement is not sufficient to establish the absence of a device to transfer property for less than full and adequate consideration to the objects of the transferor's bounty.

(2) The treatment of the first two requirements as independent codifies the holding in *St. Louis County Bank v. U.S.*, 674 F.2d 1207 (8th Cir. 1982) (*accord*, *Estate of Lauder v. Commissioner*, 60 T.C.M. 977 (1990)), and reverses the holding in *Roth v. United States*, 511 F. Supp. 653 (E.D. Mo. 1981).

Treas. Reg. § 25.2703-1(b)(2).

d. A right or restriction is treated as comparable to similar arrangements entered into by persons in an arms' length transaction if the right or restriction would have been obtained in a fair bargain among unrelated parties in the same business dealing at arms' length.

(1) A right or restriction is considered to be similar to one arrived at in a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business.

(2) This determination will generally entail a consideration of such factors as:

(a) The expected term of the agreement;

(b) The current fair market value of the property;

(c) Anticipated changes in value during the term of the agreement; and

(d) The adequacy of any consideration given in exchange for the rights granted.

Treas. Reg. § 25.2703-1(b)(4)(i).

(3) Evidence of general business practice.

(a) Evidence of general business practice is not met by showing isolated comparables.

(b) If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods.

(c) It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement.

(d) If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

Treas. Reg. § 25.2703-1(b)(4)(ii).

e. *Smith III v. U.S.*, 94 AFTR2d 2004-5283 (W.D. Pa. 2004).

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), *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.

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 a not 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.

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 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.

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 a decedent rather than as gifts made by a 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.

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

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 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 IRS also disputed the reported value of five parcels of land owned by the decedent, this discussion only deals with the stock valuation issue.

Court's Opinion. After determining that the estate was not entitled to have the burden of proof shifted to the government 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 before the enactment of I.R.C. § 2703, 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 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.

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 that were parties to 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 could have sued 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, at the time the right or restriction is entered into to, the terms must be comparable to similar arrangements entered into by persons 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 entered into, 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 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 government had argued that basing the estate tax value on the price in the 1995 FSA, which was in turn based on the 1994 Agreement, an agreement among unrelated parties, did not satisfy the test because the 1994 Agreement 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 in the 1994 Agreement was reasonable, multiple comparables were in fact considered.

While not discussed by the court, the regulatory exception discussed below did not apply in this case. 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.

2. Regulatory exception.

   a. A right or restriction is considered to meet each of the three requirements under I.R.C. § 2703(b) if more than 50% by value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family.

      (1) Consequently, in such a case the agreement would have to satisfy only the first three requirements under the case and regulatory law before the adoption of Chapter 14; *i.e.*, fixed or formula price, restriction applicable during life, and estate obligated to sell at death.

   b. In order to meet this exception, the property owned by the unrelated parties must be subject to the right or restriction to the same extent as property owned by the transferor.

   c. Members of the transferor's family are the transferor, applicable family members (the transferor's spouse, ancestors of the transferor and transferor's spouse, and spouses of such ancestors) and any lineal descendants of the parents of the transferor or the transferor's spouse, and natural objects of the transferor's bounty.

      (1) Any property held by a member of the transferor's family under the indirect ownership rules applicable to I.R.C. § 2701 is treated as held only by a member of the transferor's family; *i.e.*, no double attribution to nonfamily members. Treas. Reg. § 25.2703-1(b)(3).

3. If property is subject to more than one right or restriction, the failure of a right or restriction to satisfy the three requirements described above does not cause any other right or restriction to fail to satisfy those requirements if the other right or restriction otherwise meets those requirements.

    a. Whether separate provisions are separate rights or restrictions, or are integral parts of a single right or restriction, depends on all the facts and circumstances. Treas. Reg. § 25.2703-1(b)(5).

4. According to the explanation of the Senate Finance Committee's proposal, 136 Cong. Rec. S15629, S15683 (daily ed., Oct. 18, 1990), I.R.C. § 2703 does not otherwise alter the requirements for giving weight to a buy-sell agreement.

    a. For example, it leaves intact present law rules requiring that an agreement have lifetime restrictions in order to establish the value of the business at death, that the price be fixed or determinable, and that the estate be obligated to sell at the price determined under the agreement.

D. Modifications of Buy-Sell Agreements.

1. A right or restriction that is substantially modified is treated as a right or restriction created on the date of modification.

    a. Section 2703 applies to a buy-sell agreement entered into before October 9, 1990 if it is substantially modified after October 8, 1990.

    b. Note that if a buy-sell agreement intended to satisfy the statutory exception is substantially modified, the terms of the agreement must be reviewed to determine whether they are comparable to similar arrangements entered into by persons in an arm's length transaction as of the date of the substantial modification.

2. The regulations provide some guidance as to what will be considered a substantial modification.

    a. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a de minimis change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification.

    b. If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless it can be shown that updating would not have resulted in a substantial modification.

c. The addition of any family member as a party to a right or restriction (including by reason of a transfer of property that subjects the transferee family member to a right or restriction with respect to the transferred property) is considered a substantial modification unless:

(1) The addition is mandatory under the terms of the right or restriction; or

(2) The added family member is assigned to a generation (determined under the generation-skipping transfer tax rules (I.R.C. § 2651)) no lower than the lowest generation occupied by individuals already party to the right or restriction. Treas. Reg. § 25.2703-1(c)(1); Treas. Reg. § 25.2703-1(d), Example 2.

3. The following are not considered substantial modifications:

a. A modification required by the terms of a right or restriction;

b. A discretionary modification of the agreement containing the right or restriction if the modification does not change the right or restriction (for example an amendment to change the company's name or registered agent, Treas. Reg. § 25.2703-1(d), Example 3);

c. A modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate; and

d. A modification that results in an option price that more closely approximates fair market value.

Treas. Reg. § 25.2703-1(c)(2).

E. Effective Dates.

1. Section 2703 applies to any right or restriction created or substantially modified after October 8, 1990. RRA 90 § 11602(e)(1)(A)(ii)(II); Treas. Reg. § 25.2703-2.

2. The final regulations were effective on January 28, 1992.

3. For transactions occurring before January 28, 1992, and for purposes of determining whether an event occurring before January 28, 1992 constitutes a substantial modification, taxpayers may rely on any reasonable interpretation of the statutory provisions. The proposed regulations and the final regulations are considered reasonable interpretations of the statute. Treas. Reg. § 25.2703-2.

F. Planning.

1. Nonfamily-controlled entities.

a. If more than 50% of a business is owned by nonfamily members or persons who are not objects of the transferor's bounty, the traditional rules applicable to establishing the estate tax value of the business through the use of a buy-sell agreement should apply.

(1) In such a case, there will be no requirement that the agreement be a bona fide business arrangement and not a testamentary device.

(2) The regulations should expand this exception to apply when the same family owns no more than 50% of the interests or when two or more unrelated persons each own more than a de minimis interest in the business. In the real world, two or more unrelated parties are not likely to agree to a lower price for the business interest just to reduce estate taxes, since the amount passing to his or her beneficiaries would be reduced.

b. A buy-sell agreement among unrelated parties, or in cases where no family controls the entity, may not be required to satisfy any of the historical requirements in order for the value of the interest to be determined by the price established under the agreement.

(1) If the parties were dealing at arm's length at the time the agreement was executed, a court should be reluctant to require the estate of a deceased owner to report for estate tax purposes a value for the interest in excess of the proceeds the estate receives in a sale pursuant to the buy-sell agreement.

(2) However, in a case dealing with a nonfamily-controlled corporation, *Estate of Walon L. Carpenter*, 64 T.C.M. (CCH) 1274 (1992), the court, in holding that the purchase price established under a buy-sell agreement was the proper value for estate tax purposes, did refer to the traditional test.

(a) The court stated:

(i) As we pointed out in *Estate of Bischoff v. Commissioner* [Dec. 34,702], 69 T.C. 32, 39 (1977), it has long been recognized that a buy-sell agreement in effect at the date of a decedent's death may fix the value of the

stock of a closely held corporation if: (1) It is an enforceable agreement, (2) it applied to the stock during the lifetime of the decedent as well as at his death, and (3) it had a bona fide business purpose rather than being testamentary in nature. The fact that there is a family relationship between the individuals to an agreement does not cause such agreements always to be ignored, but the lack of such relationship has been considered evidence of a lack of testamentary intent by the agreement.

(b) The court found that because there was a business purpose for the agreement and the price was at least an arm's length negotiated price, the agreement was reasonable at the time it was entered into.

(c) Note that in this case the purchase price under the agreement for the decedent's stock (50% of the total outstanding shares) was $107,073, whereas one-half of the value of the assets received by the remaining shareholder upon the liquidation of the corporation two months after the decedent's death was $538,615.

2. Family-controlled entities.

a. Modifications of buy-sell agreements entered into before October 9, 1990 should be carefully scrutinized to avoid losing the grandfather protection.

(1) If the existing buy-sell agreement satisfies the requirements applicable to such agreements before the effective date of I.R.C. § 2703, the price determined under the agreement will establish the value of the family-owned business interest for estate tax purposes.

(2) If a family member becomes an owner after October 8, 1990, and adding him or her as a party to the agreement would be considered a substantial modification, a separate agreement with the new owner may avoid losing the grandfather protection for the original agreement.

b. If a buy-sell agreement will have to satisfy the three requirements under the statutory exception to I.R.C. § 2703 in order to establish the value for estate tax purposes, the most difficult requirement to

satisfy for family-owned businesses in many cases will be the third requirement.

(1) The third requirement states that, at the time the right or restriction is created, the terms of the right or restriction must be comparable to similar arrangements entered into by persons in an arm's length transaction.

(2) This may require assembling evidence at the time the buy-sell agreement is entered into.

(3) In comparing *Hall Estate v. Commissioner*, 92 T.C. 312 (1989)) and *Estate of Walon L. Carpenter*, 64 T.C.M. (CCH) 1274 (1992), with *St. Louis County Bank v. U.S.*, 674 F.2d 1207 (8th Cir. 1982), and *Estate of Lauder v. Commissioner*, 60 T.C.M. 977 (1990), it is obvious that a formula price under a buy-sell agreement will not be effective for establishing the value for estate tax purposes if:

(a) There is no evidence that an attempt was made to arrive at a formula price based on objective standards at the time the parties entered into the agreement;

(b) The nature of the business changed considerably since the original formula was established; or

(c) The agreement was not enforced with respect to transfers occurring before the decedent's death.

c. If the value of the business interest established by a buy-sell agreement among related parties may be disregarded for estate tax purposes, careful attention should be given to the source of payment of any estate tax on the value of the interest in excess of the purchase price under the agreement.

(1) State law may require the purchaser to pay the additional tax if the state's estate tax apportionment statute applies.

(2) The agreement may require the purchaser to pay any additional tax attributable to the additional value under I.R.C. § 2703.

d. The buy-sell agreement's effect on the marital deduction should be considered separately since the interest's value for marital deduction purposes may be reduced, even though its value for

estate tax purposes is established without regard to the buy-sell agreement.

(1) In *Estate of Renaldi*, 97-2 U.S.T.C. 60,281 (Ct. Cl. 1997), the Court of Claims held that stock passing to a trust designed to qualify as a QTIP trust did not qualify for the QTIP election because the son had a right under the decedent's will to purchase the stock at less than fair market value, despite the fact that the stock was redeemed at fair market value before the QTIP election was made.

(2) In Technical Advice Memorandum (TAM) 9139001, a trust designed to qualify for the marital deduction as a QTIP trust was funded with shares subject to an option held by the son to purchase the shares at book value. The IRS held that since the son had a power to appoint the assets to someone other than the spouse (namely, himself) for less than full and adequate consideration, the QTIP requirements were not satisfied. See also TAM 9147065.

e. Note that an appraiser may value an interest in a closely held business not subject to a buy-sell agreement at a lower value than if there were such an agreement because of the lack of marketability of the interest and the uncertainty as to the future of the business caused by the absence of such an agreement.

3. The *True* case: Effect of buy-sell agreements on transfer tax valuation.

a. Facts of the Case. In *Estate of True v. Commissioner*, T.C. Memo 2001-167, decided July 6, 2001, *aff'd*, 94 AFTR 2004-7039 (10th Cir. 2004), Judge Beghe provided taxpayers with a detailed analysis of when the purchase price contained in a buy-sell agreement will be effective for establishing the value of an interest in the entity for transfer tax purposes. The case involved transfers by Dave True in 1993 and his wife, Jean True, in 1994, and transfers from the estate of Dave True, who died on June 4, 1994. Beginning around 1950, Dave True began to amass ownership interests in a number of companies involved in the oil exploration and transportation business and in operating cattle and dude ranches. All but one of the companies were either partnerships or S corporations. By 1994, all but one of the companies were owned by Dave True, his wife, and his three sons, all of whom were active in the businesses. One company, White Stallion Ranch, Inc. ("White Stallion"), was owned 50% by Dave True and his family, and 50% by Dave True's brother, Allen, and his family. All of the companies, other than White Stallion, had buy-sell agreements that provided for a purchase price equal to the tax book value (the book

value of the assets of the company determined on a tax accounting basis), after excluding certain assets. All of the agreements, except the one involving White Stallion, required a withdrawing owner to sell and the other owners to purchase the withdrawing owner's interest at the purchase price determined under the agreement. The agreement for White Stallion had a similar provision with respect to each family group; *i.e.*, if any member of Dave True's family withdrew, the remaining members of Dave True's family were required to purchase the withdrawing family member's interest at the purchase price determined under the buy-sell agreement. However, if a family group wanted to dispose of all its interests in White Stallion, the other family group only had a right of first refusal to purchase the shares of White Stallion held by the other family group at the same price contained in a bona fide offer received from a third party.

b. Court's Opinion. There were four issues to be decided by the court:

(1) Did the book value price specified in the buy-sell agreements control the estate and gift tax values of the interests in the True companies (referred to as the "buy-sell agreement issue");

(2) If the True family buy-sell agreements did not control values, what were the estate and gift tax values of the interests (referred to as the "valuation issue");

(3) Did Jean True make gift loans when she transferred interests in the True companies to her sons in exchange for interest-free payments received approximately 90 days after the effective date of the transfers (referred to as the "gift loan issue"); and

(4) Were petitioners liable for valuation understatement penalties under I.R.C. § 6662(a), (g), and (h) (referred to as the "penalty issue")?

Only the buy-sell agreement issue is dealt with here. Although the decision in True is based on the law before the enactment of I.R.C. § 2703, which applies special rules in determining the effect of a buy-sell agreement on the value of an interest in a business entity for transfer tax purposes, much of the court's analysis will nevertheless be relevant in applying I.R.C. § 2703 to buy-sell agreements entered into on or after October 9, 1990, the effective date of I.R.C. § 2703.

Judge Beghe first described the development of the legal standards that apply in determining when a buy-sell agreement will determine the estate tax value of an interest in a business entity. Based on the cases decided after the issuance of Treas. Reg. § 20.2031-2(h) in 1958, and Rev. Rul. 59-60, 1959-1 C.B. 237, Judge Beghe applied the so-called *Lauder II* test, which was applied in *Estate of Lauder v. Commissioner*, T.C. Memo 1992-736. Under the *Lauder II* test, the formula price under a buy-sell agreement will be binding for federal estate tax purposes if:

(1) The offering price was fixed and determinable under the agreement;

(2) The agreement was binding on the parties both during life and after death;

(3) The agreement was entered into for bona fide business reasons; and

(4) The agreement was not a substitute for a testamentary disposition.

Judge Beghe noted that after the issuance of Reg. § 20.2031-2(h), the courts shifted their attention to the last two prongs, which had only been alluded to in some of the earlier cases. The last two prongs were treated by courts in the later cases as two separate requirements; *i.e.*, the agreement had to be entered into for a bona fide business reason and it could not be a substitute for a testamentary disposition. The court cited, in addition to the *Lauder* case, *Dorn v. United States*, 828 F.2d 177 (3d Cir. 1987), and *St. Louis County Bank v. United States*, 674 F.2d 1207 (8th Cir. 1982).

Under the facts in True, the parties agreed that the offering price was fixed and determinable under the agreement and the agreement was entered into for bona fide business reasons (to preserve family ownership and control of the True companies). Despite the IRS' contention that the agreements were not enforceable under state law, Judge Beghe found all the agreements, except the one for White Stallion, were binding during lifetime and after death.

Judge Beghe noted that in evaluating whether a buy-sell agreement was a substitute for a testamentary disposition, greater scrutiny is applied to intra-family agreements restricting stock transfers in closely held businesses than to similar arrangements between unrelated parties. He noted that in *Lauder* the analysis was

organized into two categories: those factors indicating that a buy-sell agreement was not the result of arm's-length dealing or was designed to serve a testamentary purpose (referred to as the "testamentary purpose test"), and tests to determine whether a buy-sell agreement's formula price reflected full and adequate consideration in money or money's worth (referred to as the "adequacy of consideration test").

Under the *Lauder II* test, the following factors were indicia that the agreement was not the result of arm's-length dealing or was designed to serve a testamentary purpose:

(1) The decedent's ill health when entering into the agreement;

(2) The lack of negotiations between the parties before executing the agreement;

(3) The lack of (or inconsistent) enforcement of the buy-sell agreement;

(4) The failure to obtain comparables or appraisals to determine the buy-sell agreement's formula price;

(5) The failure to seek professional advice in selecting the formula price;

(6) The lack of a provision in the buy-sell agreement requiring the periodic review of the stated fixed price;

(7) The exclusion of significant assets from the formula price; and

(8) The acceptance of below-market payment terms for purchase of the decedent's interest.

Under the facts in the *True* case, Dave True's ill health was not a factor (he was not in ill health when the agreements were entered into), and the agreements were either enforced or appropriate waivers were executed when it was appropriate to vary from the terms of the agreements for valid business reasons. However, there were no negotiations between the parties before executing the agreements, there was no effort to obtain comparables or appraisals to determine the appropriate formula price, professional advice was not sought in selecting the formula price, there was no provision requiring a periodic review, and significant assets were excluded from the formula price. Consequently, Judge Beghe opined that Dave True's business arrangements with his children

fulfilled his testamentary intent, as evidenced by his will and ancillary estate planning documents.

The second category of factors concerns the adequacy of consideration test. Although Judge Beghe noted that, in general, the adequacy of consideration was determined as of the date the buy-sell agreement was executed, in exceptional circumstances the adequacy of consideration and the conduct of parties after the buy-sell agreement was executed would be examined if intervening events within the parties' control caused a wide disparity between the buy-sell agreement's formula price and fair market value. In the case of the True companies' buy-sell agreements, the tax book value formula for companies that engaged in exploratory drilling for oil and gas and in operating cattle ranches substantially understated the value of the assets held in the various companies. For example, the method of depletion for tax purposes and deductions for feed and other costs incurred to raise livestock created a significant difference in tax book value and financial accounting book value.

Consequently, Judge Beghe concluded that the True family buy-sell agreements were substitutes for testamentary dispositions. He stated:

> To summarize, we have found facts indicating that the buy-sell agreements at issue in these cases (1) were not the result of arm's-length dealings and served Dave True's testamentary purposes and (2) included a tax book value formula price that was not comparable to a price that would be negotiated by adverse parties dealing at arm's-length and would not, over time, be expected to bear a reasonable relationship to the unrestricted fair market value of the ownership interests in the True companies. In *Lauder II*, certain facts regarding how the agreement was entered into allowed us to infer that the buy-sell agreements served testamentary purposes. We then went on to determine whether consideration was full and adequate, to resolve whether the formula price was binding for estate tax purposes. After considering all the circumstances, and particularly the arbitrary manner in which the formula price was selected, we concluded that the agreements were adopted for the principal purpose of achieving testamentary objectives and were not binding for estate tax purposes. [citations omitted]
>
> Similarly, in the cases at hand we have weighed all material facts and concluded that the True companies' buy-sell

agreements were substitutes for testamentary dispositions. Therefore, the fourth prong (non-testamentary disposition prong) of the *Lauder II* test has not been satisfied.

In determining the effect of the buy-sell agreement for gift tax purposes, Judge Beghe noted that because making a gift is a voluntary act, "it is well settled that restrictive agreements, such as the buy-sell agreements at issue in the cases at hand, generally do not control value for federal gift tax purposes." Finally, because the agreements did not represent a bona fide business arrangement and were a device to pass the decedent's shares to the natural objects of his bounty for less than full and adequate consideration, they would have no effect on estate tax value.

Among the various arguments of the taxpayers was the contention that the court was retroactively applying the rules under I.R.C. § 2703 to the True companies' buy-sell agreements, which were executed before the effective date of I.R.C. § 2703. Specifically, prior to the enactment of I.R.C. § 2703, no court had ever required a taxpayer to demonstrate that the buy-sell agreement in question was comparable to similar arm's-length arrangements between unrelated parties. Although the court stated that the arm's-length requirement was only one factor in determining whether a buy-sell agreement was intended to serve as a substitute for a testamentary disposition, even if it treated the arm's-length requirement as a "super factor" in its analysis, it was not a retroactive application of I.R.C. § 2703. Judge Beghe noted that the case law before the enactment of I.R.C. § 2703 demonstrated that the courts were more likely to find that a buy-sell agreement's price determined estate tax value under Reg. § 20.2031-2(h) if the agreement was comparable to that which would be derived (or actually was derived) from arm's-length dealings between adverse parties.

c. Analysis of the Opinion. The True case demonstrates that the enactment of I.R.C. § 2703 did not significantly change the rules for determining whether a buy-sell agreement among related parties would establish the value of an interest in a business entity for transfer tax purposes. The first two requirements under I.R.C. § 2703(b), that the agreement be a bona fide business arrangement and not a device to transfer the interest to members of the decedent's family for less than full and adequate consideration in money or money's worth, were already being applied by the courts as separate factors in determining whether a buy-sell agreement's formula price would be effective for establishing the transfer tax value. The third requirement, that the terms of the agreement must be comparable to similar arrangements entered into by persons in arm's-length transactions, could be viewed as a new requirement.

However, as Judge Beghe pointed out, evidence of comparable terms in buy-sell agreements among unrelated parties was the means by which taxpayers demonstrated that the first two requirements were satisfied where the entity was family-controlled.

In affirming the Tax Court's decision, the Tenth Circuit specifically overruled *Brodrick v. Gore*, 224 F.2d 892 (10th Cir. 1955), which held that the price under a buy-sell agreement would establish the value for estate tax purposes if the agreement was binding on the estate. The Tenth Circuit also pointed to the fact that Dave True eliminated his daughter from his estate plan once she sold her interests in the various companies as evidence that the buy-sell agreements were testamentary devices.

4. The *Blount* Case: Buy-sell agreement fails to satisfy either the law before 1990 or I.R.C. § 2703. T.C. Memo. 2004-116.

a. Facts of the Case. 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 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 for the 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, 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 1, 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 be disregarded in determining the value for federal estate tax purposes.

b. 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. However, the Tax Court limited the deficiency to the amount in the IRS' notice of deficiency.

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 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 taxpayers 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 second requirement, *i.e.*, 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 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, 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 did not have to determine whether the modified agreement was a bona fide business arrangement.

c. Analysis of the Opinion. From a technical standpoint, the court's disregarding the modified buy-sell agreement for purposes of 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 ended 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. Court of Appeals Decision. 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.

IV. OTHER SPECIAL VALUATION RULES UNDER CHAPTER 14

A. Transfers of Partnership and LLC Interests.

1. I.R.C. § 2701 ignores the value of applicable retained interests in a partnership or LLC for purposes of determining the value of subordinate equity interests transferred to the transferor's spouse and descendants and spouses of descendants of the transferor and the transferor's spouse. I.R.C. § 2701(a)(1), (a)(3)(A), and (e)(1).

   a. "Applicable retained interests" are certain senior equity interests (*i.e.*, equity interests that carry a preferred right to income or capital distributions) retained by the transferor and the transferor's spouse and ancestors and spouses of ancestors of the transferor or the transferor's spouse. I.R.C. § 2701(a), (b), and (e)(2); Treas. Reg. § 25.2701-3(a)(2)(ii).

   b. A "senior equity interest" is an applicable retained interest to the extent it gives the holder (1) an extraordinary payment right or (2) a distribution right (the right to receive distributions from the

entity) if the transferor and members of the transferor's family control the entity. I.R.C. § 2701(b)(1).

(1) An extraordinary payment right is the right to put or call the interest (*i.e.*, to force the entity to purchase the interest from the holder or to require the entity to sell an interest in the entity to the holder), to convert the interest into a subordinate equity interest, or to compel the liquidation of the interest (essentially a put right). I.R.C. § 2701(b)(1)(B); Treas. Reg. § 25.2701-2(b)(2).

(2) The transferor and members of the transferor's family (defined for this purpose as including descendants of the parents of the transferor or the transferor's spouse, as well as ancestors and spouses of ancestors of the transferor and his or her spouse) control an entity if any of them is a general partner in a limited partnership (or presumably a member-manager in a manager-managed LLC) or together they own 50% or more of the equity interests in the entity. I.R.C. § 2701(b)(1), (b)(2).

(3) A distribution right does not include (i) a right to distributions with respect to any interest that is junior to the rights of the transferred interest, (ii) any liquidation, put, call, or conversion right, or (iii) any right to receive any I.R.C. § 707(c) guaranteed payment of a fixed amount. I.R.C. § 2701(c)(1)(B).

c. However, the value of distribution rights, which are, qualified payment rights are not ignored. I.R.C. § 2701(a)(3).

(1) A qualified payment right is the right to receive a fixed amount or an amount based on a fixed interest rate from the entity at least annually, or, if the amount is not paid in the current year, to receive the accumulated unpaid amounts in subsequent years before other equity interest holders receive distributions from the entity. I.R.C. § 2701(c)(3), Treas. Reg. § 25.2701-2(b)(6).

(a) For example, a holder of cumulative preferred stock has a qualified payment right.

(2) Although a qualified payment right is valued at fair market value for purposes of determining the value of the initial transfer unless it is combined with an extraordinary payment right, the entity's subsequent failure to pay the qualified payment on a timely basis may result in an

increase in the holder's taxable gifts if he or she transfers a qualified payment right during life or in the holder's taxable estate if the right is held at death. Treas. Reg. §§ 25.2701-2(a)(4), 25.2701-4(a), and (c).

2. Certain payment rights fall outside the definition of distribution rights completely and thus are not ignored in valuing an applicable retained interest.

    a. These rights include mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under I.R.C. § 707(c), and nonlapsing conversion rights. Treas. Reg. § 25.2701-2(a)(4).

    b. A guaranteed payment right, which entitles the holder to receive a fixed amount at a specified time, is also valued at fair market value when determining the value of a transferred subordinate equity interest. Treas. Reg. § 25.2701-2(b)(4)(iii).

        (1) For example, an individual has a guaranteed payment right if he or she is entitled to receive $2,000 a year from the entity for his or her lifetime.

3. The effect of I.R.C. § 2701 is to reduce the value of interests older family members continue to hold and increase the value of interests transferred to younger family members by applying the subtraction method of determining the value of a transferred interest when I.R.C. § 2701 applies.

    a. Under this method, the value of any equity interests retained by the older family members, disregarding applicable retained interests and distribution rights that are not qualified payment rights, is subtracted from the value of all family-held interests in the entity.

    b. The remainder is the value assigned to the subordinate equity interests and other equity interests held by the family in the entity. Treas. Reg. § 25.2701-1(a)(2); *see also* Treas. Reg. § 25.2701-3 for specific methodology.

    c. Because in most cases it is the subordinate equity interests that have been transferred to younger family members, the amount of taxable gifts by the older transferring family members is increased by the same amount that the value of their retained equity interests is reduced.

4. Transfer tax savings may be obtained by transferring to younger family members equity interests that will absorb the future growth in the entity's value.

a. For example, an older family member starting a new business with little initial value will incur a small taxable gift if he or she gives all the residual interests to younger family members and retains a senior equity interest that is valued at zero because it is not a qualified payment right.

(1) Any subsequent increase in value will inure to the younger family members without further gift tax consequences.

b. Likewise, a tax-free shift in value occurs if the value of a business increases at a rate that exceeds the discount rate used in determining the value of a qualified payment right or guaranteed payment right retained by the older family member.

(1) Although the value of the qualified payment right or guaranteed payment right will reduce the value of the taxable gift, any payments actually made will be included in the older family member's estate unless consumed.

(2) In addition, any unpaid or late payments, compounded at the discount rate used to value the qualified payment right, will be included in the transferor's taxable gifts.

5. Nonetheless, in most situations the family can best achieve its tax and nontax goals by avoiding the application of I.R.C. § 2701 altogether.

a. I.R.C. § 2701 is not operative if there is only one class of equity interest in the entity, despite differences in voting rights, rights to manage the entity, or exposure to liability. Treas. Reg. § 25.2701-1(c)(3).

b. Only one class of entity will exist if distributions of operating revenue and liquidating proceeds are based on capital accounts and the capital accounts are maintained in a manner that reflects the financial investment of the owners in the enterprise from time to time, taking into account profits retained in the entity and losses allocated to the owners. Treas. Reg. § 25.2701-1(c)(3).

(1) For example, if Smith's capital account has a balance of $10,000 and the capital account balances of all the owners is $100,000, Smith would receive ten percent of all distributions and would be allocated ten percent of all tax items.

(2) To reflect the owner's financial investment in the entity, an owner's initial capital account should:

(a) Equal the fair market value of the owner's initial capital contribution;

(b) Be increased by any additional capital contributions, the owner's distributive share of the entity's profits, and the amount of any of the entity's liabilities that are assumed by the owner or that are secured by property distributed to the owner by the entity; and

(c) Be decreased by the amount of cash and the fair market value of any property distributed to the owner, the owner's distributive share of the entity's losses, and the amount of any liabilities of the owner that are assumed by the entity or that are secured by any property contributed by the owner to the entity.

Treas. Reg. § 1.704-1(b)(2)(iv).

(3) If there are any gifts to the entity by a person who is not an owner, the capital accounts of the owners should be increased on a pro rata basis to reflect the fair market value of the property.

(4) Finally, if an owner makes a non-pro rata capital contribution to the entity or the entity makes a non-pro rata distribution to an owner, the capital accounts of the owners should be adjusted to reflect the then fair market value of the assets held by the entity immediately before the capital contribution or distribution. Treas. Reg. § 1.704-1(b)(2)(iv)(d)-(f).

(a) The capital account of the contributor or the distributee should be adjusted to reflect the fair market value of the property contributed or distributed. Treas. Reg. § 1.704-1(b)(2)(iv)(b).

6. If capital accounts are properly maintained, basing distributions on relative capital account balances of the owners will ensure that only one class of equity exists.

a. In this regard, the regulations under I.R.C. § 2701 state that special allocations to satisfy specific requirements in subchapter K (the partnership taxation rules), such as the special allocation rules of I.R.C. §§ 704(b) and 704(c)(1)(A), will not create a second class of equity. Treas. Reg. § 25.2701-1(c)(3).

b. In addition, such allocation of income, gain, loss, deduction and credit items will eliminate several other potential tax problems.

(1) Allocation of tax items according to relative capital account balances will avoid the complex rules under I.R.C. § 704(b) dealing with the substantial economic effect of special allocations of tax items.

(2) Also, the family partnership rules under I.R.C. § 704(e) require that the allocation of a partnership's income must be proportional to the capital interests, after allocating to a donor partner reasonable compensation for services he or she rendered to the partnership. Treas. Reg. § 1.704-1(e)(3).

(3) Finally, maintaining one class of equity interest will avoid the possible triggering of a gift by an inadvertent lapse under I.R.C. § 2704(a), which can occur if an older family member loses the right to liquidate his or her retained subordinate equity interest because of a transfer of a senior equity interest to a younger family member.

B. Lapsing Voting and Liquidation Rights.

1. I.R.C. § 2704(a) treats the lapse of a voting or liquidation right as a taxable transfer for gift, estate and generation-skipping transfer tax purposes, but only if the individual holding such right and his or her family control the entity both before and after the lapse. I.R.C. § 2704(a)(1).

a. For purposes of I.R.C. § 2704, "member of the family" means the individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any sibling of the individual, and any spouse of such ancestor, descendant or sibling. I.R.C. § 2704(c)(2).

b. Control is defined in the same manner as it is defined for purposes of applying the special valuation rules under I.R.C. § 2701. I.R.C. § 2704(c)(1).

2. The value of the deemed transfer is determined by valuing all interests held immediately before the lapse by the individual, as if the lapsed voting or liquidation right still existed, and subtracting the fair market value of the same interests after the lapse (*i.e.*, under normal valuation rules). I.R.C. § 2704(a)(2).

a. The pre-lapse value of the interests is measured immediately after the lapse, but as if the lapsed voting or liquidation right still

existed, so as to take into account any loss in value attributable to factors other than the lapse itself. Treas. Reg. § 25.2704-1(d), (f).

b. For example, if the lapse occurs because of the death of the holder of the interest and the holder of the interest was a key employee, the reduction in the value of the interest may be partially attributable to the loss of the key employee and not entirely due to the lapse of the voting or liquidation right. See Treas. Reg. § 25.2704-1(f), Example 1.

3. The application of I.R.C. § 2704(a) can be avoided if there are no lapsing voting or liquidation rights to begin with.

a. However, depending upon the capital structure of the entity, a lapse may occur when interests in the entity are transferred, even though the voting and liquidation rights with respect to the transferred interests do not lapse. I.R.C. § 2704(b).

b. Under the regulations, if an older family member transfers a senior equity interest, such as a preferred partnership interest, to a younger family member and as a result loses the right to liquidate his or her retained subordinate equity interest, such as a residual partnership interest, the lapse of the right will be treated as a taxable transfer. Treas. Reg. § 25.2704-1(c)(1), (f), Examples 7 and 8.

c. This could occur, for example, if an older family member transfers a frozen partnership interest that would be considered a senior equity interest and retains a residual interest, and as a result reduces his or her partnership interest below that amount required to prevent a continuation of the partnership in the event of the withdrawal of a general partner.

(1) The transferring older family member may be a general partner in a limited partnership whose withdrawal from the partnership would be treated as a dissolution event, requiring the consent of all (or in some states a majority) of the remaining partners to continue the limited partnership.

(2) If the limited partnership interest transferred by the older family member represented all his or her remaining limited partnership interest or reduced the older family member's partnership interest below a majority interest, then he or she could, depending upon state law, lose the right to cause a liquidation of the partnership by withdrawing as a general partner and voting not to continue the limited partnership.

(3) Consequently, the regulations would treat the transfer of the limited partnership interest in this case as a lapse of the general partner's right to liquidate.

4. In some cases, older family members may want to retain voting rights or management rights while they are alive, but want the rights to lapse upon their death so that younger family members receiving the interests pursuant to the older family member's estate plan will not succeed to the voting or management rights.

a. If the entity is structured with at least one other general partner or, in the case of an LLC, member-manager, the decrease in the value of the transferred interests at death because of the lapse of the management or voting right may not be significant, since before death the decedent did not have control as a result of the existence of the other general partner or member-manager.

b. Whether there was a lapse of a liquidation right would depend on whether the deceased general partner or member-manager also had a right to liquidate his or her interests.

(1) In the case of an LLC, state law dictates whether the withdrawal or death of a member causes a dissolution event under its default rule.

(2) In the case of a limited partnership, if the partnership agreement provided that the partnership would not dissolve upon the withdrawal or death of a general partner if another general partner remained, there would be no lapse of a right to cause a dissolution under state law.

(a) However, a provision in the limited partnership agreement providing for the continuation of the limited partnership in the event of a general partner's withdrawal if there is at least one other general partner may be viewed as an applicable restriction under I.R.C. § 2704(b), and as such would be ignored for purposes of determining whether there has been a lapse of the right to liquidate.

(b) Under the Uniform Limited Partnership Act (ULPA) or the Revised Uniform Limited Partnership Act (RULPA), most states require an affirmative provision in the limited partnership agreement regarding continuation in the event of a general partner's withdrawal. *See, e.g.*, Ariz. Rev.

Stat. Ann. § 29-344(4) (West 1998); Del. Code Ann. tit 6, § 17-801(3) (1997); N.Y. Partnership Law § 21-801(d) (McKinney 1998).

(c) Such a provision would more closely resemble the type of applicable restriction covered by I.R.C. § 2704(b).

(d) On the other hand, if under state law the default rule is a continuation of the limited partnership in the event of a withdrawal of a general partner when there is at least one other general partner absent a contrary provision in the limited partnership agreement, I.R.C. § 2704(b) should not apply.

C. Applicable Restrictions.

1. Under I.R.C. § 2704(b), a restriction on the right of an owner to cause a liquidation of the entity or of his or her interest in the entity will be disregarded as an "applicable restriction" for purposes of determining the value of an interest transferred to a member of the transferor's family if the entity is controlled by the family before the transfer and the family can remove the restriction, or the restriction will lapse, after the transfer.

a. However, a limitation on the right of an owner of an interest in an entity to cause the entity to be liquidated or to have his or her interest liquidated is not an applicable restriction if the limitation is no more restrictive than the state's default rule. I.R.C. § 2704(b)(3)(B); Treas. Reg. § 25.2704-2(b).

b. Therefore, a restriction on the right of a limited partner or a member of an LLC to withdraw from the entity and receive value for his or her interest is not an applicable restriction if state law does not give the limited partner or member such a right at all.

(1) The fact that the family could override the state's default rule and allow a limited partner or a member to withdraw and receive value for his or her interest does not change this result.

(2) If the regulations under I.R.C. § 2704(b) had provided that an applicable restriction is any restriction that could be overridden by the family regardless of the default rule under applicable state law, then the holder of shares in a family-controlled corporation would be treated as having the right to put his or her interest to the corporation and receive fair market value for his or her interest, since the family could always agree to such a transaction.

(3) Fortunately, the regulations, consonant with the policy expressed in the Committee Reports that Chapter 14 was not designed to eliminate minority interest discounts, look to the state's default rule for purposes of determining whether an applicable restriction exists. H.R. Conf. Rep. No. 101-964 (1990) at 1137.

(4) Judge Jacobs, in *Kerr v. Commissioner*, 113 T.C. No. 30 (1999), held that an applicable restriction is only a restriction on an owner's right to cause a liquidation of the entity, and not a restriction on an owner's right to have his or her interest redeemed.

(a) If correct, this holding would substantially narrow the scope of I.R.C. § 2704(b).

(b) The holding with respect to I.R.C. § 2704(b) in the *Kerr* case has been followed in *Harper v. Commissioner*, T.C. Memo 2000-202 (2000); *Knight v. Commissioner*, 115 T.C. 506 (November 30, 2000); and *W.W. Jones, II v. Commissioner*, 116 T.C. 121 (March 6, 2001).

(c) Note that these cases would not apply to the right of a general partner to cause a dissolution of the limited partnership, because such a right would be a right to cause a liquidation of the entity, not just the liquidation of the general partner's interest.

(d) In upholding the Tax Court's decision that the restrictions in the limited partnership agreements were not applicable restrictions, the Fifth Circuit based its holding on the fact that the University of Texas had to consent to removing the restrictions and, therefore, the Court did not have to answer whether a restriction on the owner's right to have his or her interest redeemed was an applicable restriction. *B. P. Kerr v. Commissioner*, 2002-1 U.S.T.C. 60,440.

2. A general partner in a general or limited partnership always has the right to withdraw and receive value for his or her interest.

a. Under the Uniform Partnership Act of 1914, the withdrawal of a general partner also causes the dissolution of the partnership, even though the remaining partners in a partnership for a definite term or particular undertaking can always agree to continue the business

of the former partnership by forming a new partnership. Unif. Partnership Act § 29 *et seq*.

b. Under the Revised Uniform Partnership Act (RUPA), in a partnership that has a definite term or that is organized for a specific undertaking, a majority of the remaining partners may agree to continue the partnership after an event of dissolution, but the general partner who withdraws is presumably still entitled to receive value for his or her interest. *See also* Unif. Ltd. Partnership Act § 801 (1985).

c. A general partner withdrawing from either a general or limited partnership may be subject to liability for a premature withdrawal, but the potential liability for a premature withdrawal would be disregarded as an applicable restriction since it would not be pursuant to the state's default rule but based on the terms of the partnership agreement.

3. If a general partner withdrawing from a limited partnership also owns a limited partnership interest, he or she may also have the right to have his or her limited partnership interest liquidated.

a. If under state law the withdrawing partner has the right to withhold consent as a limited partner to the continuation of the limited partnership even though it was his or her withdrawal that caused the dissolution event, and state law requires the consent of all the remaining partners to continue the partnership, he or she would have a right to withhold consent and cause a dissolution of the limited partnership.

(1) He or she would then be entitled to receive value for his or her limited partnership interest in addition to his or her general partnership interest.

b. On the other hand, if only those limited partners holding a majority-in-interest were required to consent to the continuation of the limited partnership and the withdrawing general partner did not hold a majority-in-interest of the limited partnership interests, then he or she would not be able to cause a dissolution of the partnership and would not be able to have his or her limited partnership interest liquidated.

c. Also, if only the nonwithdrawing limited partners were required under state law to consent to the continuation of the limited partnership, a withdrawing general partner could not cause the dissolution of the limited partnership because he or she would not have the right to refuse consent.

d. Furthermore, in most states a limited partnership agreement may provide that if there is more than one general partner, the withdrawal of one of the general partners does not cause a dissolution event.

(1) As discussed above, such a provision may be treated as an applicable restriction and therefore disregarded for purposes of valuing a limited partnership interest held by a general partner at death.

(a) Consequently, the value of the deceased general partner's limited partnership interest would presumably be based on what he or she would have been entitled to receive under state law if he or she withdrew from the limited partnership.

(2) However, if state law provides for continuation as the default rule, a general partner would not have a right to have his or her limited partnership interest liquidated when there are at least two general partners.

4. The potential problems caused in a limited partnership by the right of a general partner to withdraw at any time under state law is avoided in an LLC formed in a state that does not give a member a right to withdraw and has a default rule that provides for continuity of life.

a. In this situation, an interest in an LLC will have the same characteristics as shares of stock in a corporation for purposes of I.R.C. § 2704(b).

b. Under every state's corporation law, a shareholder has no right to demand that the corporation redeem his or her stock and cannot unilaterally cause a dissolution of the corporation, unless he or she owns a certain percentage of the shares (in most states, more than two-thirds). *See, e.g.*, Ala. Code § 10-2B-14.02(f) (1997); Va. Code Ann. § 13.1-742(E) (Michie 1997).

c. If the default rule of a state's LLC statute requires unanimous consent to dissolve the LLC, an interest in an LLC may be entitled to a larger discount than shares in a corporation, which in most states can be dissolved by shareholders owning more than two-thirds of the voting shares, since dissolution of the LLC will be less likely. *See, e.g.*, Va. Code Ann. Sec. 13.1-1046.2.

5. The right of a limited partner or member of an LLC to withdraw and receive value for his or her interest depends upon state law.

a. He or she may have no right to withdraw absent a right granted in the operative agreement.

b. He or she may have a right to withdraw absent a provision to the contrary in the operative agreement.

(1) Prior notice, such as six months, may be required.

(2) He or she may be entitled to receive fair value for his or her interest based on his or her right to receive distributions, which may be the same as a going concern value and not a liquidation value.

c. If the limited partnership or LLC has a fixed term, withdrawal may not be permitted until the end of the term.

(1) Setting a term could be viewed by the IRS as an applicable restriction, although this would be an unreasonable expansion of the statute.

6. Although I.R.C. § 2704(b) may be avoided if the right entity is formed in a state that denies an owner the right to withdraw and provides continuity of life as the default rule, the IRS has taken the position that a restriction on an owner's right to have his or her interest liquidated must also pass muster under the I.R.C. § 2703 exceptions before it will be factored into the valuation of the interest.

a. In other words, even though the restriction is not an applicable restriction under I.R.C. § 2704(b), the restriction will still be disregarded for transfer tax valuation purposes if it is not commercially reasonable. I.R.C. § 2704(b)(3)(A). *See, e.g.*, TAM 9736004, TAM 9730004, and TAM 9725002.

b. However, a solid argument can be made that in any closely held business entity, the owners do not give one another the right to require the entity to redeem his or her interest at any time at a value approaching the fair market value of the interest and ignoring any discounts for lack of control and lack of marketability.

(1) Usually an owner has the right to have his or her interest redeemed upon certain stated events and the value is not necessarily based on the fair market value, but may be based on the ability of the entity to pay for the redeeming owner's interest without jeopardizing the financial viability of the entity.

(2) Unfortunately, the courts probably will have to decide what restrictions are reasonable.

7. If someone other than a family member can prevent the withdrawal of another member, the restriction will not be treated as an applicable restriction under I.R.C. § 2704(b). Treas. Reg. § 25.2704-2(b).

   a. Therefore, another way of avoiding I.R.C. § 2704(b) would be to add a nonfamily member, such as a charitable organization, as an owner of the entity, and requiring the consent of all the owners in order for a partner or member to withdraw.

   b. Note that the Fifth Circuit in upholding the Tax Court's decision in the *Kerr* based its holding on the fact that a non-family member had to consent to remove the restrictions.

   c. In the family-owned business context, adding a nonfamily member as an owner may not be palatable.

8. It could be argued that an interest in a limited partnership or LLC should be valued as an assignee's interest rather than an interest possessing all the rights of a limited partner or member, because there is no certainty that a transferee of the interest would be treated as a limited partner or member.

   a. All states currently require the consent of some or all of the other owners before a transferee becomes a limited partner or member.

   b. An assignee would only have the right to receive the distributions that the transferor would have received, but no other rights, such as any right under state law to have his or her interest liquidated.

   c. However, if the interest transferred became an assignee interest rather than a limited partnership interest, any difference in value (arguably very little) would be treated as a lapse under I.R.C. § 2704(a) and the assignee interest may not qualify for the annual exclusion.

D. GRATs.

1. Complying with the Code and regulations.

   a. In general.

      (1) A qualified annuity interest is an irrevocable right to receive a fixed amount, which must be payable to or for the benefit of the term holder for each taxable year of the term.

      (2) A right of withdrawal, whether or not cumulative, is not a qualified annuity interest.

(3) The annuity payment may be made after the close of the taxable year, provided that the payment is made no later than the date by which the trustee is required to file the income tax return of the trust for the taxable year (without regard to extensions). Treas. Reg. § 25.2702-3(b)(1)(i).

(4) A fixed amount is either a stated dollar amount payable periodically, but not less frequently than annually, or a fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually.

(5) However, the stated dollar amount or the fixed fraction or percentage is a qualified interest only to the extent it does not exceed 120 percent of the stated dollar amount or the fixed fraction or percentage payable in the preceding year. Treas. Reg. § 25.2702-3(b)(1)(ii).

(a) Any excess will not be taken into account in determining the value of the retained interest.

(b) Although income of the trust in excess of the annuity amount may be paid to or for the benefit of the holder of the qualified annuity interest, the right to the excess income will not be taken into account in valuing the qualified annuity interest.

Treas. Reg. § 25.2702-3(b)(1)(iii).

(6) If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of Treas. Reg. § 1.664-2(a)(1)(ii), relating to adjustments for any incorrect determinations of the fair market value of the property in the trust. Treas. Reg. § 25.2702-3(b)(2).

(7) In addition, the governing instrument must contain provisions meeting the requirements of Treas. Reg. § 1.664-2(a)(1)(iv), relating to the computation of the annuity interest in the case of short taxable years and the last taxable year of the term. Treas. Reg. § 25.2702-3(b)(3).

(8) A modification made to the final regulations eliminates the necessity of making a payment of a pro rata portion of the fixed amount for the first taxable year when the trust is created on a date other than January 1.

(a) Of course, a pro rata payment may be required for the final year if it is a short year.

T.D. 8536, May 4, 1994, amending Treas. Reg. § 25.2702-3(b)(3).

(9) Finally, the governing instrument must prohibit additional contributions to the trust. Treas. Reg. § 25.2702-3(b)(4).

(10) There are other governing instrument provisions that apply to both qualified annuity interests and qualified unitrust interests.

(a) To be a qualified annuity interest or qualified unitrust interest, the interest must be either a qualified annuity interest in every respect or a qualified unitrust interest in every respect.

(i) For example, an interest that provides for the payment each year of the lesser of a fixed amount of the initial trust assets or a fixed percentage of the annual value of the trust assets is not a qualified interest.

(ii) However, the interest may consist of the right to receive each year a payment equal to the greater of (x) a stated dollar amount or a fixed percentage of the initial trust assets or (y) a fixed percentage of the annual value of the trust assets.

(iii) In such a case, the value of the retained interest for purposes of I.R.C. § 2702 will be the greater of the two values.

Treas. Reg. § 25.2702-3(d)(1).

(b) The interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust. Treas. Reg. § 25.2702-3(d)(1).

(c) The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the transferor or an applicable family member retaining a qualified interest prior to the expiration of the qualified interest. Treas. Reg. § 25.2702-3(d)(2).

(d) The governing instrument must fix the term of the annuity or unitrust interest.

(e) The term chosen must be one of the following: the life of the term holder, a specified term of years, or the shorter of those periods. Successive term interests for the benefit of the same individual are treated as the same term interest. Treas. Reg. § 25.2702-3(d)(3).

(f) Finally, the governing instrument must prohibit commutation of the interest of the transferor or applicable family member and the payment of the annuity or unitrust amount with the trust's own note, debt instrument, option or similar financial arrangement. Treas. Reg. § 25.2702-3(b)(1)(i); 3(c)(1)(i); and 3(d)(5)(i).

b. The IRS has indicated that it will not issue private letter rulings when the term is less than five years or the value of the remainder interest is less than 10% of the value of the transferred assets.

2. Problem areas.

a. *Walton* GRATs.

(1) It should be possible to set the amount and term of the retained interest to eliminate any taxable gift, because the value of the remainder interest is zero.

(a) However, most commentators would suggest the remainder interest have some value to avoid an argument that there is a dry trust (hence no trust at all) and to avoid a *Proctor* issue (there is no incentive for the IRS to audit the transaction.)

(2) The IRS initially took the position that the value of the retained interest had to be reduced to take into account the fact that the grantor might die before all the annuity payments had been made, even though the trust agreement provided that any remaining payments would continue to the grantor's estate.

(a) Most commentators thought the IRS was wrong.

(b) However, if the IRS was correct, a GRAT could not be zeroed out unless a so-called contingent spousal

interest were created, which presented problems of its own.

(3) In *Walton v. Commissioner*, 115 T.C. No. 41 (December 22, 2000), the tax court held as invalid an example in the regulations that indicated that the grantor's retained interest in a GRAT must be valued as a right to receive payments for only the shorter of the term of the retained interest or the grantor's life, even though the GRAT provided that the annuity would continue to be paid to the grantor's estate if the grantor died before the termination of the grantor's interest.

(4) The IRS recently issued amended regulations to comply with the holding in the *Walton* case.

(a) The final regulations make it clear that, if the balance of the annuity payments is paid to the grantor's estate, the value of the retained interest would be based on the value of the annuity payments for the term and not the shorter of the term or the grantor's life.

(b) The amended regulations contain the following revised example:

A transfers property to an irrevocable trust, retaining the right to receive five percent of the net fair market value of the trust property, valued annually, for ten years. If A dies within the ten-year term, the unitrust amount is to be paid to A's estate for the balance of the term. The interest of A (and A's estate) to receive the unitrust amount for the specified term of 10 years in all events is a qualified unitrust interest for a term of 10 years.

(c) As a result, it will be possible to structure the GRAT so that there is no gift because the actuarial value of the retained interest is equal to the fair market value of the transferred assets.

b. Marital deduction issues.

(1) There is some controversy over how to insure that the remaining value of the trust assets qualifies for the marital deduction in the event the grantor dies during the term of the GRAT.

(2) One method would provide that:

(a) The remaining annuity payments plus any income earned by the trust assets over the annuity amount be paid to the estate at least annually;

(b) The remainder interest in the trust be paid to the grantor's estate; and

(c) The grantor's will give any interests received by the grantor's estate from the GRAT to the surviving spouse or a trust designed to qualify for the marital deduction.

c. To ensure that any in-kind distributions from the GRAT do not trigger taxable gain to the trust, grantor trust status should be retained at least until last annuity payment is made.

(1) In some cases, it may be desirable to retain grantor trust status after the grantor annuity interest terminates for other reasons.

E. QPRTs.

1. Complying with I.R.C. § 2702 and the regulations thereunder.

a. Where trust property consists of a residence to be used as a personal residence by persons holding term interests in such trust, a transfer of an interest in that trust is not subject to the special valuation rules under I.R.C. § 2702.

(1) Under the regulations, there are two types of personal residence trusts, a personal residence trust (PRT) and a qualified personal residence trust (QPRT). Treas. Reg. § 25.2702-5(a).

(a) An individual is limited to holding a term interest in two personal residence trusts (including qualified personal residence trusts) at the same time. Treas. Reg. § 25.2702-5(a).

(i) Trusts holding fractional interests in the same residence are treated as one trust for this purpose. Treas. Reg. § 25.2702-5(a).

(b) A personal residence of a term holder is either the principal residence of the term holder (within the meaning of I.R.C. § 1034, relating to tax-free

rollover treatment), one other residence of the term holder (within the meaning of I.R.C. § 280A(d)(1), relating to the 14 day or ten percent rule for rental property, but without regard to I.R.C. § 280A(d)(2), relating to special rules deeming personal use), or an undivided fractional interest in either. Treas. Reg. §§ 25.2702-5(b)(2)(i) and 25.2702-5(c)(2)(i). Note that I.R.C. § 1034 was repealed by the Taxpayer Relief Act of 1997.

(i) A personal residence may include appurtenant structures used by the term holder for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes, taking into account the residence's size and location.

(ii) The fact that a residence is subject to a mortgage does not affect its status as a personal residence.

(iii) A residence does not include any personal property; e.g., household furnishings.

Treas. Reg. §§ 25.2702-5(b)(2)(ii) and 25.2702-5(c)(2)(ii).

(c) A residence is a personal residence only if its primary use is as a residence of the term holder when occupied by the term holder. The principal residence may be used in an activity meeting the requirements of I.R.C. § 280A(c)(1) or (4) (relating to deductibility of expenses in connection with business use and day care services), provided that such use is secondary to use of the residence as a residence.

(i) A residence is not used primarily as a residence if it is used to provide transient lodging and substantial services are provided in connection with the provision of lodging; e.g., a hotel or a bed and breakfast.

(ii) A residence is not a personal residence if, during any period not occupied by the term holder, its primary use is other than as a

residence. Treas. Reg. §§ 25.2702-5(b)(2)(iii) and 25.2702-5(c)(2)(iii).

(d) If spouses hold interests in the same residence (including community property interests), the spouses may transfer their interests in the residence (or a fractional portion of their interests in the residence) to the same personal residence trust, provided that the governing instrument prohibits any person other than one of the spouses from holding a term interest in the trust concurrently with the other spouse. Treas. Reg. §§ 25.2702-5(b)(2)(iv) and 25.2702-5(c)(2)(iv).

b. Requirements Applicable to PRTs.

(1) The governing instrument of a PRT must prohibit the trust from holding, for the original duration of the term interest, any asset other than one residence to be used or held for use as a personal residence of the term holder and qualified proceeds.

(2) A residence is held for use as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence.

(3) During the original duration of the term interest, the residence may not be sold or otherwise transferred by the trust or used for a purpose other than as a personal residence of the term holder.

(4) Expenses of the trust, whether or not attributable to trust principal, may be paid directly by the term holder of the trust. Treas. Reg. § 25.2702-5(b)(1).

(5) Qualified proceeds, which may be held by a PRT, means the proceeds payable as a result of damage to, or destruction or involuntary conversion (within the meaning of I.R.C. § 1033) of, the residence held by a PRT, provided that the governing instrument requires that the proceeds (including any income thereon) be reinvested in a personal residence within two years from the date on which the proceeds are received. Treas. Reg. § 25.2702-5(b)(3).

(a) The drafter of the regulations has stated that insurance policies on the residence may also be held in the trust.

(6) Although the drafter of the regulations has stated that commutation of the term holder's interest is not permitted, the regulations do not require the trust instrument to prohibit commutation.

(a) Also, if the trust were silent on the ability of the parties to commute the term holder's interest, and they later did so, the federal tax consequences of the commutation are unclear.

(7) Finally, pursuant to an amendment to the regulations adopted on December 22, 1997, the governing instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse, at any time after the original duration of the term interest during which the trust is a grantor trust.

(a) A sale or transfer to another grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse, unless the residence is transferred for no consideration to another grantor trust of the grantor or the grantor's spouse pursuant to the express terms of the trust and the other grantor trust prohibits the sale or transfer of the property to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse.

(b) The prohibition does not apply to a distribution after the grantor's death for no consideration or to a distribution after the expiration of the retained trust term to the grantor's spouse for no consideration pursuant to the express terms of the trust.

Treas. Reg. § 25.2702-5(b)(1).

c. The governing instrument of a QPRT must contain the following provisions:

(1) Any income of the trust must be distributed to the term holder not less frequently than annually. Treas. Reg. § 25.2702-5(c)(3).

(2) Distributions of corpus must be prohibited to any beneficiary other than the transferor prior to the expiration of the term interest. Treas. Reg. § 25.2702-5(c)(4).

(a) Consequently, the transferor may retain a reversionary interest.

(b) It is unclear whether the transferor may retain a power of appointment over the trust assets.

(3) The trust must be prohibited, for the entire term of the trust, from holding any asset other than one residence to be used or held for use as a personal residence, cash for specified purposes, certain improvements, and insurance policies on the residence. Treas. Reg. § 25.2702-5(c)(5)(i).

(4) Commutation of the term holder's interest must be prohibited. Treas. Reg. § 25.2702-5(c)(6).

(5) The governing instrument may permit additions of cash to a QPRT and permit the trust to hold additions of cash in a separate account, in an amount that, when added to the cash already in the account for such purpose, does not exceed the amount required for expenses, improvements, or purchase of a new or replacement residence.

(a) The trust may hold cash for the payment of trust expenses (including mortgage payments) already incurred or reasonably expected to be paid by the trust within six months of the date the addition is made.

(b) The trust may hold cash for improvements to the residence to be paid by the trust within six months from the date the addition is made.

(c) Finally, the trust may hold cash for purchase by the trust of the initial or a replacement residence, provided that the purchase is made within three months of the date the trust is created, in the case of the purchase of the initial residence, or three months after the cash has been transferred to the trust, in the case of the purchase of a replacement residence.

(i) In addition, the trustee must have previously entered into a contract to purchase the initial or replacement residence.

Treas. Reg. § 25.2702-5(c)(6).

(d) If additions of cash to the trust are permitted, the governing instrument must require that the trustee determine, not less frequently than quarterly, the amounts held by the trust in excess of the amounts permitted and must require that any excess amounts be distributed immediately thereafter to the term holder. Treas. Reg. § 25.2702-5(c)(5)(ii)(A)(2).

(e) The governing instrument must also require, upon termination of the trust holder's interest in the trust, any amounts held by the trust that are not used to pay trust expenses due and payable on the date of termination (including expenses directly related to termination) be distributed outright to the term holder within 30 days of termination. Treas. Reg. § 25.2702-5(c)(5)(ii)(A)(2).

(6) The governing instrument may permit improvements to the residence to be added to the trust and may permit the trust to hold such improvements, provided that the residence, as improved, meets the requirements of a personal residence. Treas. Reg. § 25.2702-5(c)(5)(ii)(B).

(7) The governing instrument may permit the sale of the residence and may permit the trust to hold proceeds from the sale (sale proceeds) of the residence in a separate account. Treas. Reg. § 25.2702-5(c)(5)(ii)(C).

(8) The governing instrument may permit the trust to hold one or more policies of insurance on the residence.

(a) In addition, the governing instrument may permit the trust to hold, in a separate account, proceeds of insurance payable to the trust as a result of damage to or destruction of the residence (insurance proceeds).

(b) Amounts (other than insurance proceeds payable to the trust as a result of damage to or destruction of the residence) received as a result of the involuntary conversion (within the meaning of I.R.C. § 1033) of the residence are treated as insurance proceeds.

Treas. Reg. § 25.2702-5(c)(5)(ii)(D).

d. Cessation of Use as a Personal Residence held in a QPRT.

(1) The governing instrument must provide that a trust ceases to be a QPRT if the residence ceases to be used or held for use as a personal residence of the term holder.

(a) A residence is held for use as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence. Treas. Reg. § 25.2702-5(c)(7)(i).

(b) If the governing instrument does not permit the trust to hold sale proceeds, the governing instrument must provide that the trust ceases to be a QPRT upon the sale of the residence. Treas. Reg. § 25.2702-5(c)(7)(ii).

(2) If damage or destruction renders the residence unusable as a residence, the governing instrument must provide that the trust ceases to be a QPRT on the date that is two years after the date of damage or destruction (or the date of termination of the term holder's interest in the trust if earlier) unless, prior to such date, replacement of or repairs to the residence are completed or a new residence is acquired by the trust. Treas. Reg. § 25.2702-5(c)(7)(iii)(A).

(3) If the governing instrument permits the trust to hold sale proceeds or insurance proceeds, the governing instrument must provide that the trust ceases to be a QPRT with respect to all sale proceeds or insurance proceeds held by the trust not later than the earlier of the date that is two years after the date of sale or damage to or destruction or involuntary conversion of the residence, the termination of the term holder's interest in the trust, or the date on which a new residence is acquired by the trust (assuming that all the proceeds were not used to purchase the new residence). Treas. Reg. § 25.2702-5(c)(7)(ii) and (iii)(B).

(4) The governing instrument must require that, within 30 days after the date on which the trust has ceased to be a QPRT with respect to certain assets, the assets be distributed outright to the term holder or be converted to and held for the balance of the term holder's term in a separate share of the trust meeting the requirements of a qualified annuity interest.

(a) However, the governing instrument may permit the trustee, in his or her sole discretion, to elect either to distribute the assets or to convert them to a qualified annuity interest. Treas. Reg. § 25.2702-5(c)(8)(i).

(b) For assets to be converted to and held as a qualified annuity interest, the governing instrument must contain all the provisions required by the regulations with respect to a qualified annuity interest. Treas. Reg. § 25.2702-5(c)(8)(ii)(A).

(c) The term holder's right to receive the annuity payments must begin on the cessation date, which is defined as the date of sale of the residence, the date of damage to or destruction of the residence, or the date on which the residence ceases to be used or held for use as a personal residence, as the case may be. Treas. Reg. § 25.2702-5(c)(8)(ii)(B).

(d) The payment of the annuity may be deferred until the date that is 30 days after the assets are converted to a qualified annuity interest, referred to as the conversion date; provided that any deferred payment must bear interest from the cessation date at a rate not less than the I.R.C. § 7520 rate in effect on the cessation date.

(e) The trustee may reduce the aggregate deferred annuity payments by the amount of income actually distributed by the trust to the term holder during the deferral period. Treas. Reg. § 25.2702-5(c)(8)(ii)(B).

(i) The regulations do not indicate whether such income payments will be compounded based on the same rate applicable to the deferred payment.

(f) If, on the conversion date, the assets of the trust do not include a residence used or held for use as a personal residence, the annuity must not be less than an amount determined by dividing the lesser of the value of all interests retained by the term holder (as of the date of the original transfer or transfers) or the value of all the trust assets (as of the conversion date) by an annuity factor determined for the original term of the term holder's interest, using the rate determined under I.R.C. § 7520 (as of

the date of the original transfer). Treas. Reg. § 25.2702-5(c)(8)(ii)(C)(2).

(g) If, on the conversion date, the assets of the trust include a residence used or held for use as a personal residence, the annuity must not be less than an amount determined as if the trust no longer contained a personal residence multiplied by a fraction.

(i) The numerator of the fraction is the excess of the fair market value of the trust assets on the conversion date over the amount (including acquisition costs) reinvested in the new residence or expended for repairs of the existing residence, and the denominator of the fraction is the fair market value of the trust assets on the conversion date.

Treas. Reg. § 25.2702-5(c)(8)(ii)(C)(3).

e. Sale of Residence to Grantor, Grantor's Spouse, or Entity Controlled by the Grantor or the Grantor's Spouse.

(1) Pursuant to an amendment to the regulations adopted December 22, 1997, the governing instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse during the retained term interest of the trust, or at any time after the retained interest that the trust is a grantor trust.

(2) A sale or transfer to another grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse, unless the residence is transferred for no consideration to another trust of the grantor or the grantor's spouse pursuant to the express terms of the trust and the other trust prohibits the sale or transfer of the property to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse.

(3) The prohibition does not apply to a distribution after the grantor's death for no consideration or to a distribution after the expiration of the retained trust term to the grantor's spouse for no consideration pursuant to the express terms of the trust.

Treas. Reg. § 25.2702-5(c)(9).

2. Planning Issues.

a. In many cases it will be desirable to have the husband and wife create two separate QPRTs for their principal residence to achieve a fractionalization discount.

b. What qualifies as a personal residence?

(1) Can a partial interest in a residence that otherwise qualifies as a personal residence be transferred to a QPRT?

c. Also, it may be desirable to have the trust continue after the retained interest terminates, and allow the grantor to continue to live in the residence, assuming he or she pays fair market value rent to avoid inclusion of the residence under I.R.C. § 2036(a)(1).

F. Split Interests.

1. A joint purchase of a personal residence will avoid I.R.C. § 2702 if the older family member's interest qualifies as a QPRT.

2. Getting the value correct is necessary to avoid inclusion under I.R.C. § 2036(a)(1) that would occur if the older family member is deemed to have made a transfer for less than full and adequate consideration and retained to right to live in the house.

G. Installment Sales to Grantor Trusts.

1. Problem areas.

a. Seed money.

(1) One risk in the installment sale to a grantor trust technique is the argument that the grantor retained an equity interest implicating I.R.C. § 2701, an interest in the trust implicating I.R.C. § 2702, or an income interest implicating I.R.C. § 2036.

(a) One generally accepted way to avoid the problem is for the trust to have other assets equal in value to ten per cent of the total value of the assets after the installment sale (11.11% of the face amount of the note).

(b) Another method is for the beneficiaries to guarantee some of the loan amount.

(i) This raises the issue of whether the beneficiaries are making a gift to the trust.

(ii) To avoid this problem, the beneficiaries may be paid for the guarantee, but it is not clear what would be the appropriate amount.

b. Death before note paid off.

(1) Are death and the termination of grantor trust status treated as a recognition event triggering taxable income?

(2) Whether or not income is recognized, does the trust obtain an increased basis in the asset?

(3) One view would hold that the gain is recognized as the remaining installment payments are made and the asset held in the trust obtains a corresponding increase in basis.

V. ECONOMIC SUBSTANCE AND OTHER DOCTRINES

A. Form Over Substance.

1. If the substance of the transaction would result in different tax consequences than the form of the transaction, the IRS will argue that the substance should rule over the form when the result is favorable to the government, but will argue that the taxpayer's form will rule over the substance when that position is favorable to the government.

2. An example of an arrangement that could implicate the form over substance doctrine is a family partnership where the partnership is operated as a trust would be; i.e., distributions are made to family members when needed and on a non pro-rata basis.

B. Step Transaction.

1. The step transaction doctrine ignores intermediate steps for tax purposes when the intended result is the last of the series of transactions,

2. An example of a series of transactions that could implicate the step transaction doctrine would be the creation of a family partnership by older family members transferring assets to the partnership in exchange for partnership interests, followed by gifts of partnership interests to younger family members, and then the partnership is liquidated.

a. The IRS would ignore the intermediate steps and treat the series of transactions as gifts of the assets themselves rather than gifts of partnership interests, resulting in no discount in the case of

marketable assets, such as publicly traded stocks and bonds, and a fractionalization discount in the case of other assets, such as real estate.

C. Economic Reality.

1. Under the economic reality doctrine, the arrangement could be disregarded when the only reason for creating the arrangement was to achieve tax savings.

2. For example, the IRS could ignore the creation of a family partnership when there was no business or other legitimate and substantial non-tax reason for its creation.

VI. PENALTIES

A. Substantial and Gross Misstatements of Valuation Penalties.

1. There was a 20% accuracy-related penalty tax for a substantial overstatement of value (200% or more) or a 40% accuracy-related penalty tax for a gross overstatement of value (400% or more).

2. The 20% penalty also applied for a substantial understatement in value (50% or less) and the 40% penalty applied for a gross understatement in value (25% or less).

3. Section 1210 of the Pension Protect Act (the Act) lowered the thresholds for imposing the accuracy related penalties as follows:

a. The substantial overstatement penalty (20%) applies to an overstatement in value of 150% or more, and the gross overstatement penalty (40%) applies to an overstatement in value of 200% or more.

b. The substantial understatement penalty (20%) applies to an understatement in value of 65% or less, and the gross understatement penalty (40%) applies to an understatement in value of 40% or less.

4. The Act also eliminated the reasonable cause exception in the case of a gross valuation misstatement.

5. Finally, the Act imposes civil penalties and more onerous disciplinary procedures on appraisers who prepare an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross

valuation misstatement and increases the requirements for qualified appraisers and qualified appraisals.

a. For example, the appraiser can be subject to a civil penalty equal to the greater of $1,000 or 10% of the underpayment, but not in excess of 125% of the gross income received by the appraiser.

b. The penalty may be avoided if the appraiser establishes that it was "more likely than not that the appraisal" was correct.

(1) This will be difficult to prove, especially when the value determined pursuant to the appraisal was 200% greater or 40% less than the value determined to be correct.

See generally I.R.C. §§ 170, 6662, 6664, 6696 and 6695A.

B. Tax Return Preparer Penalties After Section 8246 of The Small Business and Work Opportunity Act of 2007 (the Act).

1. Affect on all tax return preparers.

a. The Act applies the penalties under I.R.C. § 6694, formerly applicable only to income tax return preparers, to preparers of all types of tax returns, including estate, gift, and generation skipping transfer tax returns.

b. The Act raises the standard for avoiding penalties from a "realistic possibility of success" to "more likely than not" standard, or, put another way, from a 33⅓% standard to a more than a 50% standard.

c. A return preparer can only avoid penalties if there is a reasonable basis for the taxpayer's position, even if there is adequate disclosure.

(1) Before the Act, penalties could be avoided if the position was not frivolous as long as it was disclosed.

d. The Act increases the penalty from $250 to the greater of $1,000 or 50% of the income derived by the tax return preparer from the preparation of the return.

2. Affect on Willful or Reckless Conduct.

a. The Act increases the penalty from $1,000 to the greater of $5,000 or 50% of the income derived by the tax return preparer.

3. Transition relief continues the reasonable basis standard without regard to the disclosure requirement for returns filed before December 31, 2007.

    a. The transitional relief does not apply to willful or reckless conduct.

I.R.C. § 6694, as amended by the Act.

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