PLANNING WITH TENANCIES IN COMMON — AN ALTERNATIVE TO AN FLP?[1]

Presented At

ABA RPTE/TAX 2009 JOINT FALL MEETING
CHICAGO, ILLINOIS
SEPTEMBER 24-26, 2009

1 The statements contained in this Outline are the authors' alone and should not be attributed to any other person and/or the respective law firms of the authors. The statements contained in this Outline should not be relied upon without separate and independent verification of their accuracy, appropriateness given the particular facts presented and/or potential tax consequences. The authors hereby disclaim any warranty as to the accuracy of the statements contained in this Outline.

TABLE OF CONTENTS

Page

SPEAKER BIOGRAPHIES

HUGH F. DRAKE is a partner in the firm of Brown, Hay & Stephens, LLP, in Springfield, Illinois, where he practices in the areas of estate planning, business planning, and estate administration. He graduated from the University of Illinois (B.A. 1992), Southern Illinois University (M.A. 1994), and the University of Illinois College of Law (J.D., *cum laude*, 1999). Hugh is very active in the Real Property, Trust and Estate Law Section of the American Bar Association – currently acting as Co-Chair of the Membership Committee, Chair of the RPTE Fellows Program and Vice-Chair of the Business Planning Group.

He is a frequent lecturer both nationally and locally, has published several articles on tax and estate planning, and has been quoted in such national publications as the *Wall Street Journal*. Locally, Hugh serves as President of the Board of Directors for Springfield Ball Charter School, the Executive Committee of the Sangamon Valley Estate Planning Council and the Steering Committee for the Young Philanthropists program of the Sangamon County Community Foundation.

Phone: (217)544-8491
E-mail: hdrake@bhslaw.com

Robert M. Nemzin

Associate, Bloomfield Hills Office

Direct: 248 258 2909
Fax: 248 258 1439
Email: nemzin@butzel.com

Robert M. Nemzin is an associate practicing in Butzel Long's Bloomfield Hills office. He concentrates his practice in the areas of Corporate, Tax, Real Estate, and Wealth Management.

Mr. Nemzin is a graduate of New York University School of Law (LL.M., Taxation, 2007). He is also a graduate of the University of Detroit Mercy School of Law (J.D., *cum laude*, 2006) where he was the Title Editor for the Law Review and a member of the Frank Murphy Honor Society and the Alpha Sigma Nu National Jesuit Honor Society. Mr. Nemzin served the Honorable Bernard A. Friedman, U.S. District Court, Eastern District of Michigan, as a Judicial Intern where he performed a variety of duties including the legal analysis of pending cases and the preparation of memoranda to aid clerks and the Judge in the disposition of pending civil and criminal matters.

Mr. Nemzin is a graduate of the University of Michigan (B.A., Communication Studies, 2003). He enjoyed many honors as an undergraduate including the following: recipient of the Albert Goodman Scholarship (1999-2000), recipient of the Communication Studies Summer Scholar (June 2002), and recipient of the G. McDonald Communication Studies Scholarship (March 2003). He also received University Honors in both the Winter 2002 and Fall 2002 semesters.

Mr. Nemzin is admitted to practice in Michigan and New York. He is a member of the American Bar Association (Section of Taxation; and Section of Real Property, Trust and Estate Law). He serves as a Fellow in the ABA Real Property, Trust & Estate Fellows Program, and presented on "Recent Developments in Estate Planning and Estate Administration with Closely-Held Businesses" at the ABA Tax/RPTE 2008 Joint Fall CLE meeting. His memberships also include the State Bar of Michigan and the New York State Bar Association.

Tye J. Klooster is an attorney in the Chicago office of the law firm of Katten Muchin Rosenman LLP. Tye represents high net worth individuals and business owners in wealth transfer and estate planning matters. Tye has extensive experience in designing and implementing sophisticated estate plans, leveraged wealth transfer techniques and business succession planning. Tye's practice also includes representing fiduciaries in the administration of estates and trusts and the formation and operation of private foundations.

Tye is a frequent speaker and author on various estate planning topics. Recent speaking engagements include presentations at ALI-ABA Estate Planning in Depth, Madison, Wisconsin, on June 14, 2009 regarding paying estate taxes in illiquid estates, at the Chicago Bar Association Trust Law Committee meeting on asset protection planning and at the Chicago Bar Association YLS Estate Planning Committee meeting on estate planning for Florida domiciliaries. Recent publications include "Beneficiary-Controlled Trusts May Lose Asset Protection," *Trusts and Estates*, December 2006, and "Blockbuster Guide to Drafting Florida Trusts," *Trusts and Estates*, February 2008.

Tye is a member of the Illinois and Florida bars. He is also a member of the American Bar Association, Illinois Bar Association and Chicago Bar Association. Tye is the immediate past Co-Chair of the CBA YLS Estate Planning Committee. Tye is a member of the Chicago Estate Planning Council, serves on the Board of Counselors of Drake University Law School, is a member of the Muchin Community of Support of Muchin College Prep, a Chicago charter school, and is a member of the American Cancer Society's Chicago Division Planned Giving Committee. Tye is also a 2009-2011 Fellow of the ABA RPTE Section.

Tye earned his B.B.A. in Finance, with honors, in 2000 from the University of Iowa. He earned his J.D., with high honors, in 2003 from Drake University Law School and his LL.M. in Taxation in 2004 from New York University School of Law. During law school, Tye served as Editor-in-Chief of the *Drake Law Review*.

Phone: (312) 902-5449
E-mail: tye.klooster@kattenlaw.com

PLANNING WITH TENANCIES-IN-COMMON — AN ALTERNATIVE TO AN FLP?

I. ATTACKS ON FLPS.[2]

A. **SERVICE ATTACKS ON FLPS**. Service attacks on FLPs have evolved over the years. The following is a short summary of the various attacks that have been waged against FLPs by the Service.

1. **No Economic Substance or Business Purpose**. Starting in the 1990s, the Service began attacking FLPs by arguing that they should be ignored for tax purposes because they lacked economic substance and/or because they were created without a valid business purpose and for the sole purpose of obtaining valuation discounts.[3] The Service lost on this issue in a number of court decisions.[4] In Estate of Dailey,[5] the Tax Court awarded attorneys fees to the estate with respect to this issue and the Service conceded that it was not justified in maintaining its position that the partnership should be ignored for tax purposes. As a result of the decision in Estate of Dailey, the Service has generally stopped making this argument.

2. **Gift on Formation**. The Service has argued that the creation and funding of an FLP, where valuation discounts are applied, is a gift to the other partners. The rational is that if a partner transfers property valued at say $1,000,000 to a FLP and receives back a limited partnership interest valued, after valuation discounts are applied, at only $650,000, then a gift of $350,000 has been made to the other partners. The Service's position is that the discounted value represents real value that did not just vanish – it was gifted. The Service has never succeeded with this argument.[6]

3. **IRC § 2703**. Section 2703(a)(2) provides that the value of any property shall be determined without regard to "any restriction on the right to sell or use *such property*" (emphasis added). Section 2703(b) provides an exception to this rule if the agreement, right or restriction is a bona fide business arrangement, is not a device to transfer such property to the decedent's family for less than full and adequate

---

[2] Part I of the outline was prepared by Tye J. Klooster of Katten Muchin Rosenman LLP, Chicago, Illinois.

[3] See e.g., TAMs 9736004, 9735003, 9725002 and 9719006.

[4] See e.g., Estate of Thompson v. Comm'r, T.C. Memo 2002-246, aff'd 382 F.3d 367 (3d Cir. 2004); Estate of Dailey v. Comm'r, T.C. Memo 2001-263; Estate of Jones v. Comm'r, 116 T.C. 121 (2001); Knight v. Comm'r, 115 T.C. 506 (2000); Estate of Strangi v. Comm'r, 115 T.C. 478 (2000).

[5] Estate of Dailey v. Comm'r, T.C. Memo 2001-263.

[6] Estate of Thompson v. Comm'r, 382 F.3d 367 (3d Cir. 2004); Stone v. Comm'r, T.C. Memo 2003-309; Estate of Jones v. Comm'r, 116 T.C. 121 (2001); Estate of Strangi v. Comm'r, 115 T.C. 478 (2000); Church v. United States, 85 A.F.T.R. 2d 2000-804 (W.D. Tex. 2000), aff'd 268 F.3d 1063 (5th Cir. 2001).

consideration in money or money's worth and its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

The Service has argued in the past that IRC § 2703(a)(2) applies to the underlying assets of a partnership, rather than the partnership interest itself and the partnership agreement represents a restriction under IRC § 2703(a)(2) that should be ignored for valuation purposes. The Service has consistently lost this argument.[7] The court in Church v. United States noted that the legislative history of IRC § 2703 indicates the purpose of this section was to address buy-sell agreements which artificially depress the value of a property interest and that a partnership agreement was not the target of the section.[8] In addition, the court in Church held that the IRC § 2703(b) safe harbor applied.[9]

The Service did not give up on the fight under IRC § 2703. In Smith v. Commissioner, the Service argued that IRC § 2703 applied not to disregard the entire partnership agreement, but only specific provisions of the partnership agreement.[10] In this case, the partnership agreement was one that fixed the price of a transferred partnership interest at less than fair market value (in Church the restriction analyzed was a restriction on an assignee becoming a partner). The court held that IRC § 2703 applied in this case and that the restriction in the partnership agreement should be ignored. The court, however, did not address whether the IRC § 2704(b) safe harbor applied, holding that issue could not be resolved on summary judgment.

The Service landed a major blow on the IRC § 2703 front in Holman v. Commissioner.[11] In this case, the parents transferred Dell stock to an FLP and ultimately made gifts of limited partnership interests for the benefit of their children. The partnership agreement contained what are fairly standard transfer restrictions – transfers are generally prohibited without the consent of the other partners (other than to permitted assignees) and if you transfer outside of these parameters then the partnership has the right to buy the limited partnership interests at fair market value (i.e., factoring in valuation discounts). The Service argued that under IRC § 2703 the transferred limited partnership interests should be valued without regard to "restrictions on the right to sell or use the partnership interest" in the partnership agreement. The taxpayer and the Service apparently agreed that IRC § 2703(a) applied. The issue was whether the IRC § 2704(b) safe harbor was applicable in this case. With respect to the bona fide business arrangement prong, the court held that the taxpayer flunked this test because there was no closely held business here that was at issue and the taxpayer's goals of disincentivizing them from giving away Dell shares and educating their children were not consistent with

---

[7] See Church v. United States, 85 A.F.T.R. 2d 2000-804 (W.D. Tex. 2000); Estate of Strangi v. Comm'r, 115 T.C. 478 (2000), aff'd 293 F.3d 279 (5th Cir. 2002).

[8] Church v. United States, 85 A.F.T.R. 2d 2000-804 (W.D. Tex. 2000).

[9] Id.

[10] Smith v. Comm'r, 94 A.F.T.R. 2d 2004-5627 (W.D. Pa. 2004).

[11] Holman v. Comm'r, 130 T.C. No. 12 (2008).

the reasoning behind this prong as spelled out in the legislative history. Note that the court could have stopped there but did not. With respect to the device test, the court used rather strange reasoning to conclude that this was a device to transfer such property to the decedent's family for less than full and adequate consideration in money or money's worth. The court reasoned that if a limited partner tried to transfer interests outside of the permitted parameters and the partnership exercised its right to purchase the interests at fair market value, the difference between fair market value of the limited partnership interests and the proportionate share of the underlying assets of the partnership would increase the value of the remaining partners. The court should have stopped after analyzing the first prong. Thankfully the court did not make a finding with respect to the third prong. In the end, IRC § 2703(a) applied and the IRC § 2704(b) safe harbor was not satisfied. The result was that this restriction in the partnership agreement was ignored and the taxpayer's valuation discount was reduced from a 49.25% discount to discounts of 22%, 25% and 16.25% in the three different years (note that the Service argued for a 28% discount).

Many FLPs will fall victim to Holman's reasoning that the IRC § 2704(b) safe harbor is not applicable because providing for continuity of ownership or control of who becomes a successor partner is not a sufficient business purpose for this test where there is not a closely held business. The result may be that these types of transfer restrictions will be ignored for valuation purposes. What is the effect of this on the overall valuation discount? Maybe not much. With respect to the repurchase option (not the general prohibition on transfer), the Service's expert believed that ignoring this restriction would have no impact on value and the taxpayer's expert believed that ignoring this restriction would cause the valuation discount to be adjusted downward by 2.4%. The Service, however, will be more confident in playing the IRC § 2703 card in audits going forward.

4. **IRC § 2704(b)**. This section provides that if there is a transfer of an interest in a corporation or partnership to or for the benefit of a member of the transferor's family and the transferor and members of the transferor's family immediately before the transfer control of the entity, then any "applicable restriction" is to be disregarded in determining the value of the transferred interest. An "applicable restriction" is defined as any restriction which effectively limits the ability of the corporation/partnership to liquidate and the restriction lapses after the transfer or the transferor or any member of the transferor's family, either alone or in collectively, has the right after such transfer to remove the restriction. Treas. Reg. § 25.2704-2(b) provides a limitation not found in the text of the statute. This regulation provides that an "applicable restriction" is a limitation on the ability to liquidate the entity that is more restrictive than the limitations that would apply under default state law generally applicable to the entity in the absence of the restriction. Many states have revised their limited partnership act to provide that a limited partner may withdraw from a limited partnership as provided in the partnership agreement and, as a result, under default state law there is no right of a limited partner to withdraw by giving notice and being paid the fair market value of the interest. As a result of this regulation and the changes made to many states' laws, the IRC § 2704(b) blade has been severely dulled. However, see Section I.D below relating to additional avenues that may be considered going forward to broaden the definition of an "applicable restriction".

Note that no case has examined the applicability of IRC § 2704 to FLPs. The only Service ruling that I am aware of is FSA 199919099 in which case the Service took the position that the provision of the partnership agreement giving the partnership a set term was an applicable restriction because it prevented the limited partner from being able to liquidate his interest on six months notice (which was the applicable default state law). Again, most state laws have been revised to change the default rule.

5. **Gifts of FLP Interests and the Gift Tax Annual Exclusion**. In Hackl v. Commissioner,[12] the Service successfully argued that gifts of LLC interests were not present interests and therefore did not qualify for the gift tax annual exclusion under IRC § 2503(b). In Hackl, the taxpayers formed an LLC and funded the LLC with tree farms that had little saleable timber. The taxpayers then made gifts of LLC interests to their family. The issue was whether the gifts were gifts of present interests that qualified for the gift tax annual exclusion under IRC § 2503(b). The Operating Agreement of the LLC had the following significant terms: (a) the manager had exclusive control of the management of the LLC, (b) the manager was to act in good faith and in the best interests of the LLC, (c) distributions of cash could be made pro rata, (d) members could not withdraw the member's capital contributions, (e) members could not withdraw from the LLC without the manager's consent, and (f) members could not assign their LLC interest without the manager's consent (and manager could dictate terms of sale) which could be withheld in the manager's sole discretion (apparently the LLC interest could still be assigned, but the assignee would have a mere assignee interest – the right to receive distributions only and no other rights). The applicability of the gift tax annual exclusion to a gift of FLP interests properly focuses on the donees' right to immediate use of property and the donees' immediate right to income of property. With respect to immediate use of the property, the donees' had no right to withdraw from the LLC, no right to demand return of capital contributions, no right to sell their interest to third parties. The court held that the Operating Agreement "foreclosed the ability of donees presently to access any substantial economic or financial benefit that might be represented by ownership units". With respect to immediate right to income, the LLC had losses and negative cash flow, distributions were in the sole discretion of the manager, there was no history of paying income and no steady flow of income. As a result of these limitations, the gift tax annual exclusion was denied. The most important facts in Hackl seemed to be the degree of control of the manager which impinged on his fiduciary duties and the fact that the members could not sell their LLC interests without the manager's approval.

A number of the Service's rulings have concluded that gifts of FLP interests qualify for the gift tax annual exclusion.[13] What facts were different in these rulings as compared to Hackl? In the taxpayer friendly rulings the interests could be assigned subject to a right of first refusal and the manager had fiduciary duties that were not compromised by language in the controlling partnership/LLC agreement. The issue

[12] Hackl v. Comm'r, 118 T.C. 279 (2002), aff'd 335 F.3d 664 (7th Cir. 2003).

[13] TAM 199131006; TAM 199346003; PLR 199415007; TAM 199944003; and PLR 199905010.

might also be avoided by gifting cash and allowing the donee to purchase FLP interests with the gifted cash.

6. **Gift of Underlying Assets and Not FLP Interests**. Where assets are contributed to an FLP and gifts of FLP interests occur at the same time or relatively shortly thereafter, the Service has successfully argued that a transfer of FLP interests (which would normally benefit from valuation discounts) is really a transfer of the underlying assets (not entitled to valuation discounts) contributed to the partnership. Reg. § 25.2511-1(h)(1) serves as the source of the Service indirect gift argument. The regulation provides that if a shareholder transfers property to a corporation for less than adequate consideration, the transferor has made a gift to the other shareholders to the extent of their proportionate interest in the corporation.

In Shepherd v. Commissioner,[14] a parent contributed assets to a partnership and half of the contribution was credited to the children's capital accounts. The Service successfully invoked Reg. § 25.2511-1(h)(1) and the Tax Court held that the parent had made an indirect gift of the amount credited to the children's capital accounts. The Eleventh Circuit affirmed.[15] Both courts, however, suggested in dicta that had the contribution been credited to the parent's capital account first, followed by a gift of the partnership interest to the children, the indirect gift argument would fail and a discount would be allowed on the transfer of partnership interests.[16] Thus, Shepherd was viewed as a case easily avoided if the proper sequence is followed.

In Estate of Jones v. Commissioner,[17] Judge Cohen of the Tax Court transformed the dicta in Shepherd into a holding. In Jones, a father made a contribution to a partnership in exchange for limited partnership interests. Immediately after making the contribution, the father gifted limited partnership interests to his children. The Service made the indirect gift argument and the Tax Court rejected it, holding that Jones is distinguishable from Shepherd in that the contribution has been actually credited to the father's capital account. Jones held that proper sequencing of the transaction could defeat the Service's indirect gift argument.

In Senda v. Commissioner,[18] husband and wife attended a tax planning seminar sponsored by Arthur Andersen in 1996 (cases beginning with the client or son-in-law attending a tax conference never end up good for the taxpayer). Thereafter, along with their children, they formed a limited partnership by agreement dated April 1, 1998. On December 28, 1998, husband contributed MCI Worldcom stock to the partnership by making a transfer between brokerage accounts in exchange for partnership interests. On

---

[14] Shepherd v. Comm'r, 115 T.C. 376, 377 (2000).

[15] Shepherd v. Comm'r, 283 F.3d 1258 (11th Cir. 2002).

[16] Shepherd v. Comm'r, 115 T.C. at 387 and 283 F.3d at 1261.

[17] Estate of Jones v. Comm'r, 116 T.C. 121 (2001).

[18] Senda v. Comm'r, T.C. Memo 2004-160, aff'd 433 F.3d 1044 (8th Cir. 2006).

the same day, husband made gifts of limited partnership interests to their children. The only books and records maintained by the partnership were brokerage account records and tax returns. Stock certificates reflecting that the partnership first, followed by the children, were the new owners were not completed until several years after the transfers. The Tax Court held, in an opinion authored again by Judge Cohen, that the transfers of stock to the partnerships and the gifts of limited partnership interests to the children should be treated as gifts of the underlying stock, without discounts, rather than gifts of discounted limited partnership interests. The Tax Court concluded that there was no evidence that the stock was contributed to the partnerships before the gifts of limited partnership interests were made to the children. In addition, there was no evidence that the stock contributions were ever reflected in the capital accounts of husband and wife. In short, the Tax Court held there had been a sequence failure. The taxpayer failed to prove that the contribution had been made to the partnership prior to the gift of limited partnership interests. The best the taxpayer could do was to show that the contribution and gifts occurred simultaneously and were in effect integrated. Judge Cohen's decision appeared to leave intact the dicta of Shepherd and the holding of Jones focusing on how Senda differed from the taxpayers failure to prove that the contribution occurred prior to the gift.

The taxpayer appealed to the Eight Circuit.[19] In its reply brief, the Service tried a different approach, arguing that Shepherd was mere dicta and that the step transaction doctrine had not been argued in Jones. In contrast, the Service argued, in Senda the step transaction doctrine had been argued pursuant to Judge Cohen's use of the phrase "integrated transaction". In short, the Service sought to eliminate the dicta in Shepherd through the step transaction doctrine. The Eighth Circuit agreed with the Service holding that the Tax Court had adopted a position inconsistent with the Shepherd dicta and the Jones holding. The Eighth Circuit found that "the tax court recognizes that even if the Senda's contribution would have first been credited to their accounts, this formal extra step does not matter." This is another round of dicta apparently rejecting the dicta in Shepherd and the holding in Jones. The issue after Senda was how much of a delay between the contribution date and the date of the gift of FLP interests is enough?

In Holman v. Commissioner,[20] the Holmans created a family limited partnership on November 3, 1999. The Holmans transferred to the FLP shares of Dell stock. The Holmans made gifts of FLP interests to their children on November 8, 1999, January 4, 2000 and February 2, 2001. The Service argued that the gift by the Holmans on November 8, 1999, which was about 6 days from the date the Dell stock was transferred to the FLP, was an indirect gift of Dell stock and not a transfer of FLP interests to which valuation discounts would be applicable. The court distinguished this case from the Shepherd and Senda cases by noting that FLP interests were not transferred before the contribution of Dell stock or at the same time. In contrast, the Holmans waited approximately 6 days and bore a real economic risk of a change in value of the

[19] Senda v. Comm'r, 433 F.3d 1044 (8th Cir. 2006).

[20] Holman v. Comm'r, 130 T.C. 12 (2008).

partnership for the 6 days that separate their transfer of the shares to the partnership and the gift. As a result, the gift tax annual exclusion was allowed.

Gross v. Commissioner[21] is a case that is similar to Holman, but 11 days elapsed between contribution to the FLP and gifts of FLP units. The assets of the FLP in this case were mostly shares of well-known companies. Again, the court held that nature of the underlying assets of the FLP were such that the transferors bore a real economic risk of a change in value during the elapsed time. The focus of these cases is now the nature of the underlying assets and whether during the elapsed time the transferor bore a real economic risk of a change in value. If the underlying assets are real property (in a normal market at least) or bonds, a significant amount of time may need to occur before transfers of FLP units will be respected. The most recent case addressing this issue, Linton v. United States,[22] is examined in Part I.B below.

7. **IRC § 2036**. More recently the Service's preferred weapon for attacking FLPs has been IRC § 2036. This Service attack on FLPs (and the means of avoiding it) has been the subject of numerous articles and presentations so I will not rehash that discussion here. Below I summarize the basic rules viewed from 1,000 feet on the Service's use of IRC § 2036 as an attack on FLPs. In Section I.B below I summarize a couple of the more recent cases.

a. *Exception for Bona Fide Sale for Adequate and Full Consideration*. IRC § 2036 does not apply if a transfer was made as part of a "bona fide sale" for "adequate and full consideration". Note that this exception to the application of IRC § 2036 is a two-part test.

The first element of the exception is that the FLP must have been created as part of a "bona fide sale". At the risk of oversimplifying this test, I believe a fair assessment of the case law at this point is whether the partnership was formed for a "legitimate and significant non-tax reason". The test no longer appears to require an arm's length transaction, with actual negotiations, the presence of additional parties and the presence of separate counsel, although these factors are considered in the determination of whether the formation of the partnership was for a legitimate and significant non-tax reason. Despite the fact that the test references only a legitimate and significant non-tax purpose, the various pronouncements and summaries of the test in various court decisions leave one to question whether in fact a business purpose is really required. In the Tax Court, the decisions in Stone,[23] Schutt,[24] Harper,[25] Thompson[26] and Strangi[27]

[21] Gross v. Comm'r, 96 T.C.M. 187 (2008).

[22] Linton v. United States, ___________ (W.D. Wash. 2009) (not published as of date of this Outline).

[23] Estate of Stone v. Comm'r, T.C. Memo 2003-309.

[24] Estate of Schutt v. Comm'r, T.C. Memo 2005-126.

[25] Estate of Harper v. Comm'r, T.C. Memo 2002-121.

phrased the test as a "nontax business reason" or note the lack of a "functioning business". The Tax Court test, however, now appears to be based on the Bongard[28] decision, which framed the test as whether or not there was a "legitimate and significant nontax" reason for forming the FLP. In the Fifth Circuit Kimbell[29] opinion the court held that "[a] transaction motivated solely by tax planning with no business or corporate purpose is without substance and is rightly ignored for tax purposes" but the court does not appear to have ultimately required a business purpose. In the Third Circuit's Turner[30] opinion, there is no statement that a business purpose is required, but the court focused much more on this than the other courts and gave a strong impression that it is an important consideration.

The second element of the exception is that the transfer to the FLP must have been for "adequate and full consideration". The test for this element now appears to be a four-part test: (a) whether the partnership interests received in exchange for the transfer were proportionate to the value of the assets contributed to the partnership, (b) the assets were properly credited to the transferor's capital account, (c) upon termination of the partnership the partners are entitled to receive distributions in proportion to their capital account balances, and (d) the transfer to the partnership was for a legitimate and significant non-tax reason.[31] Note that having a legitimate and significant non-tax reason is now important for both prongs of the exception to IRC § 2036.[32] Note, however, that a lack of a business purpose and the dissipation in value due to valuation discounts were important to the Third Circuit in the Turner[33] case.

b. *IRC § 2036(a)(1) - "Bad Facts" Cases*. Courts have held that where a taxpayer has transferred assets to a partnership and the facts and circumstances suggest that there was an implied agreement that the decedent retained the enjoyment of or would be granted access to the property transferred, the assets transferred to the partnership are properly included in the decedent's gross estate under IRC § 2036(a)(1). The court decisions have focused on various "bad facts" in finding the necessary implied agreement. The following is a list of some of the more common bad facts that the cases are targeting (note that this list

---

[26] Thompson v. Comm'r, T.C. Memo 2002-246.

[27] Estate of Strangi v. Comm'r, T.C. Memo 2003-145.

[28] Estate of Bongard v. Comm'r, 124 T.C. 6141-03 (2005).

[29] Kimbell v. United States, 244 F. Supp. 2d 700 (N.D. Tex. 2003), rev'd 371 F.3d 257 (5th Cir. 2004).

[30] Estate of Turner v. Comm'r, 382 F.3d 367 (3d Cir. 2004).

[31] Estate of Bongard v. Comm'r, 124 T.C. 6141-03 (2005).

[32] See id.

[33] Estate of Turner v. Comm'r, 382 F.3d 367 (3d Cir. 2004).

is far from complete) and that should be avoided: (a) forming the FLP at an old age; (b) forming the FLP while in bad health; (c) transferring basically all of the taxpayer's assets to the FLP (financial dependence on distributions from the partnership); (d) transferring personal use property, such as a residence, to the FLP; (e) son-in-law or power of attorney involved in the formation; (f) forming the FLP after attending a seminar; (g) commingling of FLP funds and personal funds; (h) failure to timely transfer assets to the FLP once it is formed; (i) no change of management of assets; (j) no change of underlying assets; (k) mostly passive assets; (l) taxpayer standing on all sides of the transaction; (m) no negotiations; (n) no separate counsel; (o) no true pooling of assets; (p) other entity "formalities" not followed (e.g., disproportionate distributions); and (q) use of partnership assets to pay estate/gift taxes.

c. *IRC § 2036(a)(2).* IRC § 2036(a)(2) provides that 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 for a bona fide sale for full and adequate consideration) and retained for life "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". Courts have typically only addressed this issue if the exception to IRC § 2036 and IRC § 2036(a)(1) are not applicable. Strangi[34] and Kimbell[35] are the two cases most often cited related to the IRC § 2036(a)(2) issue. However, the Supreme Court's decision in Byrum[36] is the backbone of this issue.

In Byrum, the decedent had transferred shares of stock in closely held corporations to a trust for the benefit of his children, retaining the right to vote the transferred stock, the right to remove and replace the corporate Trustee and the right to veto the sale or transfer of the trust's stock. The decedent retained stock in the closely held corporations that, along with his voting rights over the transferred stock, made him the controlling shareholder and allowed him to select the corporate directors, who ultimately decided whether and the extent to which dividends would be paid. The Service argued that as a result, the transferred stock should be included in the decedent's gross estate under IRC § 2036(a)(2). The Supreme Court held that IRC § 2036(a)(2) was inapplicable for the following reasons. First, the decedent did not have the power to make distributions of trust income and/or principal or dictate when they would be made; rather, the independent corporate Trustee had that power. Second, as a majority shareholder, the decedent owed fiduciary duties to the minority shareholders under state law. The fiduciary duties constrained the decedent's power over dividend policy and therefore precluded him from having the necessary "right" to designate under IRC § 2036(a)(2). Finally, the corporations were subject to economic realities, such as

---

[34] Estate of Strangi v. Comm'r, T.C. Memo 2003-145.

[35] Estate of Bongard v. Comm'r, 124 T.C. 6141-03 (2005).

[36] United States v. Byrum, 408 U.S. 125 (1972).

unprofitable years, new competition, litigation, government regulation and bankruptcy. And these business realties prevented the decedent from having the necessary "right" to designate who received the income.

In Strangi, the decedent owned 47% of the corporate general partner of the partnership and the son-in-law, who was also the decedent's attorney in fact, served as the manager of the general partner. With respect to the IRC § 2036(a)(2) analysis, the problematic retained powers were: (1) the general partner had the "sole discretion" to make distributions (i.e., not limited to "distributable cash" or ascertainable standards); and (2) the decedent could act with other shareholders to dissolve the partnership. The estate, relying on Byrum, argued that IRC § 2036(a)(2) did not apply. Judge Cohen (note that this was not a decision of the entire Tax Court) distinguished the facts in Strangi from those present in Byrum. In Byrum, the decedent retained the right to vote the transferred stock (and therefore could elect directors who would decide whether or not distributions were made), but the stock was given to a trust with an independent Trustee who alone had the sole discretion to make distributions, whereas in Strangi the distribution decisions were made by the decedent's attorney-in-fact as the manager of the corporation and partnership. Furthermore, in Byrum, the flow of funds was dependent on economic and business realities of a small operating enterprise that impact the earnings and dividends, whereas in Strangi these complexities are not applicable because the partnership held only investment assets (i.e., no operating business). Finally, Judge Cohen distinguished the fiduciary duties present in Byrum, from the fiduciary duties present in Strangi. Judge Cohen held that in Byrum non-related minority shareholders were present who could enforce the fiduciary duties by filing a law suit; in contrast, in Strangi the duties were owed mainly to the decedent himself and the presence of a 1% non-family shareholder (charity) was mere window dressing, as "a charity given a gratuitous 1-percent interest would not realistically exercise any meaningful oversight." Judge Cohen's IRC § 2036(a)(2) holding in Strangi is mere dicta, as she previously concluded that the transfer was subject to IRC § 2036(a)(1). The focus under IRC § 2036(a)(2) is whether the decedent retained a "right" either alone or in conjunction with one or more persons to designate the persons who would possess or enjoy the transferred property or the income therefrom. Whether the decedent retained this "right" should be based on whether there were sufficient constraints on this right under applicable state law. Judge Cohen focused on the subjective likelihood that the fiduciary duties would be enforced, whereas the Byrum decision focused only on enforceability. This analysis mandates a facts and circumstances determination and moves away from the otherwise bright-line test of the Byrum decision. The fiduciary duty limitation has previously been held applicable in intrafamily settings by courts and the Service. Judge Cohen's IRC § 2036(a)(2) analysis extends the application of this section far beyond prior court and Service applications of the section. The analysis, pushed to its outer limits, could mean that if the decedent owns any interest in a limited partnership, whether general or limited, whether 99% or 1%, the formation of the entity violates IRC § 2036(a)(2) because the decedent in conjunction with others could determine when distributions are made and when and if the entity is dissolved.

In Kimbell, the District Court held that the assets transferred to the partnership were included in the taxpayer's estate under IRC § 2036(a)(2). The District Court found that the general partner had the sole discretion to make distributions of income of the partnership and that the taxpayer had the power to at any time remove the general partner and appoint herself or anyone she desired. The District Court rejected the taxpayer's claim that Byrum applied and that the fiduciary duties she owed limited her power and thus prevented application of IRC § 2036(a)(2). The District Court held that Byrum was distinguishable on its facts and that in any event the partnership agreement specifically provided that the general partner did not owe a fiduciary duty to the partnership or to any other partner. This is another bad facts case. Unfortunately, the Fifth Circuit did not address the IRC § 2036(a)(2) with respect to transfers to the partnership because it held that the bona fide sale for full and adequate consideration exception applied. The court did, however, address this section with respect to transfers to the LLC general partner, holding: "[T]he district court's application of § 2036(a) to the LLC transfer was erroneous. Even if the transfer did not constitute a bona fide sale for full and adequate consideration, Mrs. Kimbell did not retain sufficient control of the assets transferred to the LLC to make her transfer subject to § 2036(a). Mrs. Kimbell's interest in the LLC was only a 50% interest, and son had sole management powers over the LLC. Thus, Mrs. Kimbell did not retain the right to enjoy or designate who would enjoy the LLC property. Accordingly, we vacate the ruling of the district court on this issue."

In the end, many practitioners believe Judge Cohen's analysis in Strangi of the IRC § 2036(a)(2) was erroneous and was in any event dicta and that the Kimbell District Court's reasoning was basically overruled by the Fifth Circuit. Many believe that Byrum is a significant impediment to the application of IRC § 2036(a)(2) to a properly structured FLP. Conservative practitioners recommend that the taxpayer not own an interest in the general partner of the FLP so as to avoid this issue altogether (clients, however, often insist on maintaining control).

B. SURVEY OF RECENT CASES RELATING TO ATTACKS ON FLPS.

1. **Estate of Mirowski v. Commissioner**.[37] When I first reviewed the Mirowski decision, I was shocked at how much more taxpayer friendly this FLP case is – in particular, the description of the facts - than other recent FLP cases. The Mirowski case was a decision by Judge Chiechi and was not a decision of the full Tax Court. In 1992, Ms. Mirowski created three separate irrevocable trusts for her three daughters, naming the three daughters as Co-Trustees of each trust. Ms. Mirowski named the three daughters as Co-Trustees of each trust because she wanted her daughters to work together and have a close working relationship. After Dr. Mirowski's death, Ms. Mirowski managed her financial affairs herself, although she discussed them with her daughters.

[37] Estate of Mirowski v. Comm'r, T.C. Memo. 2008-74.

She was a conservative investor, investing mostly in treasury securities. She tracked her investments on a large spreadsheet. Eventually, because of the success of the patent royalties, it became burdensome to track her investments. She had over eighty-four accounts at ten different institutions. Eventually Ms. Mirowski recognized that the Goldman Sachs account she had was significantly outperforming the investments she managed on her own. Ms. Mirowski then deposited cash and securities into her Goldman Sachs account with the intent of diversifying her holdings. Goldman Sachs diversified the holdings, but at the direction of Ms. Mirowski. At times she accepted their suggestions and at times she did not. Starting in 1999, Ms. Mirowski began thinking about ways, in addition to the three trusts, to provide for her family on an equal basis and also to allow them to work together and have a close working relationship. In May of 2000, Ms. Mirowski met with a representative from U.S. Trust in the home of one of her daughters. The U.S. Trust representative introduced Ms. Mirowski to the concept of an LLC. Ms. Mirowski engaged her attorney about the possibility of forming an LLC. The attorney sent Ms. Mirowski drafts in August of 2000. In January of 2001, on a trip to France, Ms. Mirowski developed a blister on her foot that ultimately developed into a foot ulcer. The initial diagnosis was that with proper treatment she would recover. In March of 2001, Ms. Mirowski signed an agreement to enter a retirement community. In August of 2001, the family held their annual Delaware vacation, which Ms. Mirowski did not attend given her condition. The family discussed with the attorney the plans to form the LLC, make gifts of interests in the LLC, the manner the LLC was to function and the responsibilities of the daughters with respect to the LLC. At the time of the annual family meeting and until September 10, 2001, Ms. Mirowski's health was not rapidly deteriorating. The attorney finalized the LLC documents and although Ms. Mirowski understood that certain tax benefits could result from forming the LLC, the potential tax benefits were not the most significant fact in her decision to form the LLC. The case stated that Ms. Mirowski had the following "legitimate and significant nontax purposes" for forming and transferring the bulk of her assets to the LLC: (1) joint management of the family's assets by her family; (2) maintenance of the bulk of the family's assets in a single pool of assets in order to allow for investment opportunities that would not be available if Ms. Mirowski were to make a separate gift of a portion of her assets to each of the three trusts for her daughters; and (3) providing for each of her daughters and eventually each of her grandchildren. These purposes, the court stated, were rooted in Ms. Mirowski's formative years in France, where her family worked together in the family business. The court also recognized that another legitimate, but not significant, nontax reason for the LLC was creditor protection.

Ms. Mirowski signed the LLC documentation on August 27, 2001. Four days later she was admitted to the hospital for treatment of her foot ulcer. On September 1, 2001, Ms. Mirowski transferred her 51.09% interest in the ICD patents license agreement to the LLC. On September 5, 6 and 7, Ms. Mirowski transferred a total of approximately $62 million of securities to the LLC. After the transfers, Ms. Mirowski was the sole member of the LLC. Ms. Mirowski, as was her intention prior to forming the LLC, made gifts of 16% interests in the LLC to each of the three trusts for her daughters on September 7, 2001. The gift resulted in a significant gift tax liability. After the transfers to the LLC, Ms. Mirowski retained in her individual name approximately $7.5 million of property, which were enough to meet her living expenses, but not enough to pay the gift tax. The court stated that Ms. Mirowski could have used a mix of the assets she did retain, distributions from the LLC and/or borrowed against her personal assets and her interest in the LLC to pay the gift tax.

Ms. Mirowski was admitted to the hospital for further treatment on August 31, 2007 and her condition unexpectedly deteriorated on September 10, 2001. She died on September 11, 2001. The court noted that after her death the significant nontax reasons for setting up the LLC were being satisfied (daughters working together, one pool of assets, etc.). The LLC made distributions to Ms. Mirowski's estate to allow the estate to pay the significant gift and estate tax due. The Service issued a notice of deficiency with respect to the LLC, arguing that Ms. Mirowski's gross estate should be increased by approximately $43 million and resulting in an estate tax deficiency of approximately $14 million.

The court first examined the exception to IRC § 2036 for a bona fide sale for full and adequate consideration. The court held that the test is as stated in Bongard: "[W]here the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred. The objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership's creation. A significant purpose must be an actual motivation, not a theoretical justification." The court bought the testimony of the daughters and executors regarding nontax reasons for establishing the LLC. The court held that the following were legitimate and significant nontax reasons for forming the LLC: (1) joint management of the family's assets by her family; (2) maintenance of the bulk of the family's assets in a single pool of assets in order to allow for investment opportunities that would not be available if Ms. Mirowski were to make a separate gift of a portion of her assets to each of the three trusts for her daughters; and (3) providing for each of her daughters and eventually each of her grandchildren.

The Service argued that exception to IRC § 2036 was not satisfied for the following reasons: (1) Ms. Mirowski failed to retain sufficient assets outside of the LLC to meet her anticipated financial obligations – court responded that the only financial obligation she anticipated was gift tax, and had means of paying that; (2) the LLC lacked any valid business operation – court responded that this was an investment operation; reject contention that it had to rise to the level of a "business" in order for the exception to apply; (3) Ms. Mirowski delayed forming and funding the LLC until shortly before she died – court noted that Ms. Mirowski's condition unexpectedly deteriorated; as a result, no one anticipated the significant estate tax that would result and figure out how to pay; (4) Ms. Mirowski sat on both sides of the transfers to the LLC – court stated that this reads out of IRC § 2036 the exception; and (5) distributions to Ms. Mirowski to pay gift and estate taxes, legal fees and other estate obligations – court responded that no one expected her to die so quickly.

With respect to IRC § 2036(a)(1), the Service argued that an invalid string was retained based on the following reasoning. Ms. Mirowski was the general manager and as general manager had the sole and exclusive authority to manage the LLC's affairs and to decide the timing and amount of distributions from the LLC. Ms. Mirowski could not be removed as general manager because she still held a majority interest. The court responded that as general manager Ms. Mirowski's discretion and authority was subject to the following restrictions: (1) restrictions regarding the distribution of cash flow and capital transactions – the LLC agreement mandated these distributions; she was not empowered to decide to make them or not; (2) restrictions regarding the distribution of assets upon liquidation; (3) restrictions regarding extraordinary transactions; and (4) fiduciary duties imposed by applicable state law. As a result, the court held there was no invalid express agreement of an invalid string. The Service then argued there was an implied agreement of a retained invalid string, citing the same factors it cited with respect to the bona fide sale exception. The court rejected these again. The court specifically pointed out that the use of LLC funds to pay gift and estate taxes was not an issue because other assets could have been used to pay gift taxes and no one expected her to die so quickly and generate the estate tax.

With respect to IRC § 2036(a)(2), the Service argued that with the approval of her daughters, Ms. Mirowski had the authority to dispose of assets in other than the ordinary course of business and that as the holder of a majority of the LLC interests, she alone held the power to determine the timing of the distribution of the capital transaction proceeds. Thus, Ms. Mirowski held the right, in conjunction with her daughters, to designate the person or persons who shall possesses or enjoy the proceeds of the transferred property within the meaning of IRC § 2036(a)(2). The court simply responded with the same statement it made with respect to the IRC § 2036(a)(1) analysis – because of the mandatory distributions, she did not retain an invalid string.

The following "bad facts" were present in this case: (1) age / health of taxpayer; (2) presence of U.S. Trust and daughter in originally bringing up the LLC; (3) distributions to pay gift and estate taxes and paying legal fees; (4) almost all of her assets were transferred to the LLC; and (5) funding near death. The Mirowski case is similar to the Schutt case were the court held that there was a legitimate and not theoretical nontax reason for establishing the LLC. The lesson here is that we need to provide a "road map" or a "story" to establish that the FLP satisfies the exception to IRC § 2036. Mandatory distributions of "distributable cash" or similar concept seemed to be very important to the court and served as a check against invalid IRC §§ 2036(a)(1) and (a)(2) powers.

2. **Astleford v. Commissioner**.[38] The decision in Astleford allowed multiple (tiered) discounts. The taxpayer had formed a limited partnership and transferred thereto an interest in an elder-care assisted living facility, a 50% interest in a general partnership and 14 real estate properties, including a 3,000 acre tract of land near St. Paul. The court allowed (a) an absorption discount of just over 20% for the 3,000 acre tract of land, (b) a 30% discount for the 50% interest in the general partnership; and (c)

[38] Astleford v. Comm'r, T.C. Memo 2008-128,

combined discounts of 34% and 36% for transfers of interests in the limited partnership. Apparently tiered discounts are appropriate where the lower level interest does not constitute a significant portion of the parent entity's assets (in this case the 50% interest in the general partnership constituted less than 15% of the limited partnership's assets).

3. **Estate of Hurford v. Commissioner**.[39] The Hurford case involved two issues: (a) whether the transfer of FLP interests in exchange for a private annuity was includable in the taxpayer's estate under IRC §§ 2036(a)(1), 2036(a)(2) or 2038; and (b) whether the assets contributed to the FLPs were includable in the taxpayer's estate under IRC §§ 2036(a)(1) and 2035. I will address only issue (b) in this outline. The Hurford case is an example of bad lawyering and how not to do it.

Ms. Hurford's husband died in 1999 leaving his assets between a marital trust and a bypass trust. After the husband's death, Ms. Hurford visited with her attorney to discuss the administration of her husband's estate and her own estate planning. The attorney apparently recommended a conservative approach – including outright cash gifts to consume Ms. Hurford's gift tax exemption and the creation of two FLPs to own Ms. Hurford's assets. Ms. Hurford was diagnosed with stage 3 cancer in 2000. One of Ms. Hurford's sons apparently found a different attorney who had a great bedside manner. This attorney recommended a much more aggressive approach, including forming and funding three FLPs and selling the interests to two of the three children in exchange for private annuities. The three FLPs were formed in March 2000. The court noted that much of the FLP related documentation was very sloppily completed as numerous errors and inconsistencies existed. The attorney apparently designed the FLPs so that the children made no contributions yet they received a 1% ownership interest. In addition, the attorney had Ms. Hurford take a distribution from the bypass trust and contribute these assets to the FLPs and sell the interests for a private annuity – assets that would have been excluded from her estate. Ms. Hurford filed the estate tax return for her husband and the income tax returns for the various FLPs and related entities and there were numerous discrepancies between the positions taken on the various returns. Ms. Hurford died on February 19, 2001 – 10 ½ months after entering into the private annuity transaction.

With respect to the exception to IRC § 2036, the FLP agreements listed various purposes for the FLPs, but the estate relied on asset protection and asset management as the main non-tax reasons for creating the FLPs. The court held that the FLPs did not add any greater degree of asset protection than the protection the assets already received from the marital and bypass trusts. The court also rejected the asset management non-tax reason, as the parties relationship to the assets did not change after contribution. The following "bad facts" were present: (a) financial dependence on distributions from the partnership; (b) commingling of FLP and personal funds; (c) delay in funding or properly transferring assets; (d) decedent was of old age and bad health; (e) no functioning business or meaningful economic activity (note – the court did not require a functioning business; rather, the court noted that there must be some sort of meaningful economic

[39] Estate of Hurford v. Comm'r, T.C. Memo 2008-278.

activity). The court held that the FLPs were created for the sole purpose of obtaining valuation discounts (notes that the daughter took at one of the meetings basically confirmed this). The court also held that the estate did not meet the full consideration aspect of the exception. The court held that the test is the three-part test laid out in Bongard and Kimbell, but also relied on the Bongard court's statements that "[a]ll partners in each partnership received interests proportionate to the fair market value of the assets they each transferred, and partnership formalities were respected." In this case, Ms. Hurford did not get back FLP interests in proportion to the property contributed (instead, some FLP interests went to the children) and as a result the full consideration aspect of the exception was not satisfied.

With respect to evidence of an implied agreement to retain enjoyment of property transferred to the FLPs, the court noted that Ms. Hurford used FLP assets to pay personal expenses, she transferred nearly all of her assets to the FLPs and there was no change in her relationship to the assets after the transfers to the FLPs. In the end, the transfers to the FLPs violated IRC §§ 2036(a)(1) and 2035 and the assets of the FLPs were included in Ms. Hurford's estate with no valuation discounts.

4. **Estate of Jorgensen v. Commissioner**.[40] JMA-1 was an FLP created by Mr. and Mrs. Jorgensen. When Mr. Jorgenson died, FLP interests were used to fund the bypass trust and a 35% discount was taken on the JMA-I interests. In administering Mr. Jorgensen's estate, the estate attorney wrote a couple of letters which highlighted the importance of Mrs. Jorgenson transferring additional assets to the FLP in order to take advantage of 35% valuation discounts and the significant estate tax savings that result therefrom. The estate attorney subsequently discussed Mrs. Jorgenson's estate tax issues with her son, daughter and the daughter's husband – note that Mrs. Jorgenson was not involved – and it was decided to form JMA-II to which Mrs. Jorgenson contributed marketable securities. The GPs of JMA-II were the son and daughter and they were also listed as limited partners even though they contributed nothing to the FLP. Mrs. Jorgenson then made significant gifts of FLP interest and took substantial valuation discounts. Mrs. Jorgenson later consulted with a different estate planning attorney who in a letter noted the audit risk of a gift of FLP interests with substantial valuation discounts, but also highlighted various non-tax reasons for JMA-II. The court did not buy any of these after the fact non-tax reasons highlighted in the letter – the court viewed them as self-serving and made in preparation of audit.

With respect to the exception to IRC § 2036(a)(1), the estate argued a number of non-tax reasons for creating the FLPs and the court shot down each of them. The court held that the following factors were evidence that the transfer to the FLPs was not bona fide: (a) contemporaneous written letter from estate attorney about need to fund FLPs for discounts; (b) the partnership formalities were disregarded as no books and records were maintained, no formal meetings, personal expenses were paid with partnership funds, Mrs. Jorgenson had check writing authority over the accounts even though she was not a general partner; and (c) no arm's length transaction in that Mrs. Jorgenson stood on all

[40] Estate of Jorgensen v. Comm'r, T.C. Memo 2009-66.

sides of the transaction. The court held that the lack of an arm's length transaction and that marketable securities were the assets of the FLPs were the most important factors. The full consideration prong of the exception was not argued by the Service.

With respect to invalid IRC § 2036(a)(1) strings, the following bad facts were present: (a) partnership assets were used for personal expenses; (b) partnership assets were used to pay post-death expenses, including estate taxes; (c) non-pro rata partnership distributions; (d) fiduciary duties to Mrs. Jorgenson (son and daughter were the GPs, but they were also the Co-Trustees of her Revocable Trust and had fiduciary duties to her). In the end the court held that the exception to IRC § 2036 did not apply and that Mrs. Jorgenson retained the enjoyment of assets transferred to the FLPs under IRC § 2036(a)(1) and as a result all of the assets she originally transferred to the FLPs were included in her estate with no valuation discount. One interesting aspect of this case is that underlying assets associated with FLP interests that were gifted more than three years before her death were also included in her estate under IRC § 2036(a)(1). This is interesting because IRC § 2036(a)(1) requires a retention of enjoyment of transferred property and after she transferred the FLP interests Mrs. Jorgenson had no legal rights to said property – only to the FLP interests that she retained.

5. **Estate of Miller v. Commissioner**.[41] In this case, Decedent's husband subscribed to a particular investment philosophy which related to charting of stocks. Decedent's husband taught this investment philosophy to his eldest son, Virgil. Decedent's husband predeceased her. In 2002 and 2003, Decedent transferred assets to a family limited partnership of which Virgil was the General Partner. The court examined the 2002 and 2003 transfers separately to determine whether IRC § 2036 was applicable.

With respect to the 2002 transfers, the court noted that the transfers were made for a valid non-tax reason and at a time when her health was not declining (she was old, but not ill). That non-tax reason was to maintain the Decedent's husband's investment philosophy. After the assets were transferred to the partnership, trades were more frequent and Virgil spent approximately 40 hours a week managing the assets in accordance with his father's investment philosophy. The court held that the 2002 transfers satisfied the bona fide sale for adequate and full consideration exception to IRC § 2036 because the rationale for the transfers, i.e., the continuation of the Decedent's husband's investment philosophy, was a significant non-tax reason for the partnership. The Decedent, after the 2002 transfers, retained over $1 million of assets and had access to other assets in a QTIP marital trust, which were sufficient to pay for her day-to-day living expenses.

With respect to the 2003 transfers, the court held that these transfers were made at a time when her health had declined and were made for the sole purpose of reducing estate taxes. The estate argued that these transfers were made to continue the investment philosophy with these assets as well, but the court noted that these assets could have been transferred in 2002 with the other assets if this was the case. With respect to retention of sufficient assets outside of the partnership, the court held as follows: "It is clear that

[41] Estate of Miller v. Comm'r, T.C. Memo 2009-119.

when the decision was made to further fund MFLP in May 2003, Virgil G., as trustee of decedent's trust and as general partner of MFLP, knew that MFLP funds would be needed to pay decedent's estate tax liabilities. . . . After this contribution, decedent did not retain sufficient assets to satisfy her estate tax liabilities. Although the estate argues that the distribution to decedent's trust in 2004 was simply a pro rata distribution to MFLP's partners, the funds were used to satisfy decedent's estate's tax liability. 'Part of the possession or enjoyment of one's assets is the assurance that they will be available to pay various debts and expenses upon one's death.'" The 2003 transfers were includible under IRC § 2036.

6. **Linton v. United States**.[42] In this case, H formed an LLC in November 2002. On January 22, 2003 the following occurred: (a) H gifted a 50% interest in the LLC to W, (b) H also transferred undeveloped real property, cash and bonds to the LLC, (c) H and W created trusts for their children, and (d) H and W gifted 90% of the LLC interests to the trusts for their children. The documentation whereby LLC interests were gifted to the LLC was not originally dated, but the date January 22, 2003 was filled in by the lawyer. There was apparently testimony that this date was inserted by mistake and that the gifts were actually made some time thereafter, but the court found that the testimony could not contradict the express date used on the documents. The court then examined the Shepherd, Jones and Senda cases and held that the facts of this case are similar to Shepherd and Senda because the gifts were made the same day assets were transferred to the LLC. That should have been where the court stopped, but it did not. The court went on to also hold that the step transaction doctrine applied in this case. Note that the step transaction doctrine does not appear to be applicable to these types of cases in that the step transaction doctrine ignores a set of steps where the assets at the start of the transactions ends up at the end of the transaction; in contrast, the donees in these cases never receive the assets contributed to the FLP, rather they receive FLP interests. The court also distinguished the facts of this case from the facts of Holman and Gross in that the taxpayers in this case could not show real economic risk from the purported delay – the assets contributed in this case were real estate, cash and bonds and not equities. The test at this point in time appears to focus on time of delay between contribution and gift of FLP interests, the underlying assets of the FLP and whether there is an economic risk and avoiding the step transaction doctrine.

7. **Keller v. United States**.[43] The Keller case is a United States District Court case from the Southern District of Texas. The case is a great taxpayer victory case. Bad facts present in this case: (1) assets were not actually transferred to the partnership prior to the decedent's death; (2) the decedent's old age and health; (3) borrowing from the partnership to pay estate taxes; and (4) the accountant attended an estate planning seminar (albeit, after it had already been agreed to form the partnership) The factual holdings of the case strongly favored the taxpayer. Ms. Williams was a surviving spouse

[42] Linton v. United States, ___________ (W.D. Wash. 2009) (not published as of date of this Outline).

[43] Keller v. United States, ___________ (S.D. Tex. 2009) (not published as of date of this Outline).

and had total assets of approximately $350 million which were titled in her name, a surviving spouse's trust and in a family trust created by her deceased husband. Ms. Williams was concerned about protecting family wealth from divorce creditors and had a past experience with a daughter getting divorced and family wealth dissipating as a result. She was also concerned with facilitating the administration of significant family assets. The Williams family had a significant relationship with a father and son accounting team, the Kellers, who basically served as the Williams' family office. The Kellers worked with Mrs. Williams on her goals of protecting the family wealth from divorce creditors and facilitating the administration of the family assets and recommended and investment partnership to accomplish these objectives. Mrs. Williams agreed to form the partnership, with the trusts each being a 49.5% limited partner and a separate LLC that she alone would own being the .5% general partner. Mrs. Williams intended to transfer the LLC interest to her family members. The Kellers enlisted the help of a Dallas attorney to prepare the partnership documentation and spent a considerable amount of time in reviewing and amending various drafts of the partnership documentation. It was clear that approximately $250 million of community bonds and other assets were to be transferred to the partnership. Mrs. Williams was then diagnosed with cancer, although there was no indication that death was imminent. The partnership documentation was taken to Mrs. Williams and signed by her while she was in the hospital. After the partnership documentation was signed, the Kellers filed the appropriate documentation to form the limited partnership and the LLC. They also begin working with the financial firms to formally create accounts and fund the partnership. The partnership agreement's schedule showing contributions of the partners was never completed. Mrs. Williams died before the partnership and the LLC were funded and the Kellers stopped all work relating to funding the partnership.

Keller was named as a co-executor of Mrs. Williams estate. The estate borrowed funds from the partnership to pay estate taxes, which payment was made 9 months after Mrs. Williams death and an extension was requested for time to file the estate tax return. Keller then attended an estate planning seminar which discussed the Church case. After the seminar, Keller concluded that perhaps they had been successful in funding the partnership after all. He directed that the assets be transferred and that the partnership be formally funded. Eventually a claim for refund was requested as a result of valuation discounts taken on the partnership interests. The Service ignored the claim for refund and the estate filed this action.

The court held that under Texas law the partnership had in fact been formed – there was an obligation to fund the $250 million amount, even though the schedule was left blank. The court also relied on the taxpayer's valuation expert and discounted the Service expert because the expert strayed too far away from the hypothetical willing buyer willing seller test. The court found that the formation and funding of the partnership met the bona fide sale for adequate and full consideration test under IRC § 2036. The court relied on the test laid out by the Fifth Circuit in Kimbell. The court held that the transfer was "bona fide" because it was done in good faith and the central purpose of the partnership was not to avoid taxes and in addition Mrs. Williams retained sufficient assets outside of the partnership. The court held that the adequate and full consideration test was satisfied, relying mainly on provisions of the partnership agreement that provided that amounts were to be credited to capital accounts and that the partners were to be giving partnership interests in proportion to what they contributed. The Service argued that this case was like Strangi and the court disagreed. In contrast to Strangi, in this case the decedent had not transferred nearly all of her assets to the partnership and there were no inappropriate distributions made from the partnership. In the end, this decision is a significant taxpayer victory in a bad facts case – a valuation discount of approximately 47% was allowed and the taxpayer won on the IRC § 2036 issue despite no actual funding of the partnership, taxpayer was aged and in bad health and another estate planning seminar was involved.

C. RECENT LEGISLATIVE ATTACK ON FLPS – H.R. 436.[44]

1. **Summary of Proposed Legislation**. Representative Pomeroy, D – N.D., introduced H.R. 436, Certain Estate Tax Relief Act of 2009,[45] on January 9, 2009. H.R. 436 retains the estate tax, repeals carryover basis, freezes the federal estate tax exemption at $3,500,000, freezes the maximum tax rate at 45% and imposes a surcharge on estates exceeding $10,000,000.

H.R. 436 also attacks entities that are not actively traded within the meaning of IRC § 1092.[46] Note that the attack is on all entities that are not actively traded – this includes FLPs, but it also is broader and includes entities that are actively involved in a trade or business that are not actively traded on financial markets. The bill attacks non-actively traded entities in two respects.

First, for purposes of valuing a transfer of an interest in a non-actively traded entity for estate and gift tax purposes, the value of "nonbusiness assets" held by such entity is determined as if the taxpayer had transferred the non-business assets directly and no valuation discounts are allowed and the nonbusiness assets are not taken into account in determining the value of the interest in the entity transferred. The term "nonbusiness assets" is defined very broadly as any asset which is not used in the active conduct of a trade or business. Certain "passive assets" are deemed not held in the active conduct of a trade or business. Passive assets include (but are not limited to) items such as cash or cash equivalents, stock in a corporation or any other equity, profits or capital interest in an entity, promissory notes, annuities, real property used in a real property trade or business, commodities and collectibles. In addition, if a nonbusiness asset of an entity consists of at least 10% interest in any other entity, the 10% interest in the entity is to be

[44] Much of the discussion in this section was based on a draft letter written on behalf of the ABA RPTE Section to the chairmen and ranking members of the United States House of Representatives and Senate regarding H.R. 436 (it was subsequently decided that said letter would not be sent). Drafting of the letter was coordinated by Stephanie Loomis-Price. Tye J. Klooster participated in the drafting of the letter.

[45] H.R. 436, Certain Estate Tax Relief of 2009, available at http://www.govtrack.us/congress/bill.xpd?bill=h111-436.

[46] Reg. § 1.1092(d)-1(a) defines an "actively traded" interest as property for which thee is an established financial market.

disregarded and instead the entity is to be treated as holding directly its ratable share of the assets of the other entity.

Second, for purposes of valuing a transfer of an interest in a non-actively traded entity, no discount is allowed for lack of control if the transferee and members of the transferee [within the meaning of IRC § 2032A(e)(2)] have control of such entity.

2. **Flaws of Proposed Legislation**.

a. *Tax Preference in Favor of Actively Traded Businesses*. Assume taxpayer A owns an interest in Corporation Y and taxpayer B owns an interest in Corporation Z. Corporation Y is a privately held entity that is not actively traded. Corporation Z is actively traded on an established securities market. In all other respects Corporations Y and Z are identical. If taxpayers A and B desired to transfer an interest in their entity to a child, the value of the transfer by taxpayer B would effectively reduced by a valuation discount for lack of control,[47] while the value of the transfer by taxpayer A would not be reduced by a lack of control discount as a result of H.R. 436. I fail to see any reason for such desperate treatment under these facts.

b. *Contravenes Well Established Rule of Taxing Transferred Property*. Under Reg. §§ 20.2031-1(b) and 25.2512-1 fair market value of property transferred is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts". Under this test, valuation discounts are often appropriate given the lack of control and other restrictions applicable to the transferred interest. Estate and gift taxes are levied on the fair market value of the property that is transferred. In the context of a transfer of an interest in an entity, what is transferred is an interest in the entity and not the assets owned by the entity. The transferor may have zero ability to access the assets of the entity and yet H.R. 436 would treat the transferor has having transferred the underlying assets of the entity.

c. *Will Result in Overvaluation*. H.R. 436 would result in interests in an entity being valued for estate and gift tax purposes in excess of what such interests would bring in a sale between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonably knowledge of the relevant facts. The result will be an inflated valuation for estate and gift tax purposes which will result in excessive taxation of the transferred interest.

d. *Family Control of Entity*. H.R. 436 would eliminate discounts for lack of control if after the transfer the transferee and members of the transferees family within the meaning of IRC § 2032A(e)(2) have control of such entity.

[47] The value of publicly traded stock is generally thought to reflect a lack of control discount.

Imputing control in this fashion contravenes well established law[48] and flies in the face of common sense. IRC § 2032A(e)(2) defines members of a family as including the transferee's ancestors, spouse, a lineal descendant of the transferee, a lineal descendant of the transferee's spouse, a lineal descendant of a parent of the transferee or the spouse of any such lineal descendant. H.R. 436 assumes that all families are harmonious and would necessarily work together in controlling the entity such that a valuation discount for lack of control is not appropriate. Is this presumption appropriate to your own family or to families that you have seen in practice? My personal experience has been that it is often these types of family relationships that can be the most contentious and that justify a discount for lack of control. Under the proposed legislation, a lack of control discount would be available for an entity owned by three college friends, but would be inapplicable for an entity owned by a stepmother and her two stepchildren. This does not appear to make any practical sense.

e. *Negative Impact on Small Businesses*. In the most recent election cycle were heard at nausea how important small business are to the economy. We are hearing it again in the context of raising revenue to pay for Obama's health care (insurance) reform. H.R. 436 will negatively affect the transfer of businesses that are not actively traded to the next generation – businesses that are the backbone to our economy. Most small businesses do not make it to the next generational level and this legislation will only make it more difficult. The proposed legislation will increase the value of the transferred interest and result in over taxation and the family paying estate/gift taxes on what is really non-existent value. This will forces businesses to go public or substantially increase the likelihood of a forced liquidation to pay taxes.

D. **OBAMA REVENUE PROPOSAL REGARDING IRC § 2704**. The Treasury's 2010 Fiscal Year "Greenbook"[49] was released on May 11, 2009. The Greenbook contained a proposal to modify the rules under IRC § 2704 relating to valuation discounts for FLPs.

In summarizing current law, the Greenbook provides that IRC §§ 2701-2704 were enacted to prevent reduction of transfer taxes through so-called "estate freezes" and other techniques that would reduce the value of the transferred property for transfer tax purposes but would not reduce the economic value of the transferred property to the beneficiary. Under current law, IRC § 2704(b) provides that certain "applicable restrictions" are to be ignored in valuing interests in family controlled entities for transfer tax purposes. The Greenbook referenced judicial decisions, enactment of new state statutes and additional arrangements identified by the Service as designed to circumvent IRC § 2704(b) (do you think this means FLPs?) as reasons for proposing changes to IRC § 2704.

---

[48] See e.g., Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981); Estate of Andrews v. Comm'r, 79 T.C. 938 (1982); Rev. Rul. 93-12.

[49] General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, available at http://www.ustreas.gov/offices/tax-policy/library/grnbk09.pdf.

The proposal would add an additional category of "disregarded restrictions" that would be ignored in valuing the transfer of an interest in family controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or can be removed by the transferor and/or the transferor's family. Certain assumptions spelled out in regulations would be substituted for the "disregarded restrictions" for valuation purposes. Disregarded restrictions would include the following, measured against standards prescribed by Treasury regulations and not against default state law: (1) limitations on the right to liquidate the holder's interest that are more restrictive than a standard to be identified in the regulations, and (2) any limitation on a transferee's ability to be admitted as a full partner (i.e., the concept of an "assignee interest" would be ignored). While not specifically stated, it is possible that "disregarded restrictions" may be broadened to included restrictions on management, distributions, access to information and transferability. I personally see changes to IRC § 2704 as the more likely avenue of legislative attack on FLPs as compared to legislation similar to H.R. 436.

II. REVIEW OF TENANCY IN COMMON DISCOUNT CASES AND RULINGS.[50]

As demonstrated, the Service and Congress have repeatedly attempted to reduce and/or eliminate the availability of using FLPs as a mechanism for applying discounts to the value of the property held in the FLP. Accordingly, now is an appropriate time to review another avenue for obtaining possible valuation discounts, fractionalization discounts for tenancy in common interests in property.

The majority of the cases discussing and applying tenancy in common discounts have involved interests in real property. In addition, there is some authority involving discounts applicable to artwork. The following is a summary of some of the cases and rulings addressing these issues.

A. CASES AND RULINGS INVOLVING REAL PROPERTY APPROVING PARTITION COSTS ONLY.

1. PLR 9336002 Decided May 28, 1993

A wife gave her husband a life estate in her one-half community property interest in a ranch. Following the husband's death, the husband's estate claimed a 30 percent discount on his undivided one-half interest in the ranch in his estate tax return.

The Service cited to Regulation § 20.2031-1(b) and stated that the fair market value of an interest in property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all facts.

The court cited to the possible lack of unity of ownership interests among co-owners as a disadvantage for an owner of an undivided interest in property that wishes

[50] Part II of the outline was prepared by Robert M. Nemzin of Butzel Long, Bloomfield Hills, Michigan.

to sell the interest. The court further cited that if the seller's co-owners decline to join in a sale of the property, the seller may be forced to either accept a reduced price for his interest or seek a formal partition action.

However, the Service held that in valuing the undivided interest in the property, the amount of the discount should be limited to the estimated costs of partitioning the property.

2. **TAM 199943003**
Decided November 1, 1999

The Service was asked to decide whether a discount for the decedent's undivided interest in real property was limited to the estimated costs of a partition of the real property.

The Service cited Regulation § 20.2031-1(b), stating that the fair market value of the decedent's interest in the real property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all facts.

The Service held that the appropriate fractional interest discount is a matter of fact to be resolved on the basis of the entire record. The court cited Fittl v. Commissioner, TC Memo 1986-542, stating that the method to determining fair market value of an undivided interest in property is to subtract the costs of a partition sale from the fair market value of the undivided interest.

B. **CASES AND RULINGS INVOLVING REAL PROPERTY APPROVING DISCOUNTS IN ADDITION TO PARTITION COSTS**.

1. **Propstra v. U.S**
680 F.2d 1248 (9th Cir. 1982)
Decided July 6, 1982

The decedent's estate primarily consisted of his undivided one-half interest in several parcels of real estate owned by him and his wife as community property.

The estate argued that it was entitled to discount the decedent's undivided one-half interest in the real estate held as community property by 15 percent when computing the value of the decedent's estate due to the lack of marketability of an undivided interest in real property.

The Service disallowed the 15 percent valuation discount. The estate submitted affidavits from two qualified appraisers, whose testimony showed that the value of the fractional interest in the real property would be less than a proportionate share of the fair market value of the whole. The Service presented no facts regarding the value of the property.

The court cited that the fair market value of the decedent's interest in the real property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all facts. The court refused to value the property as a whole and instead permitted a 15 percent discount.

2. **Estate of Youle v. Commissioner**
TC Memo 1989-138
Decided March 30, 1989

Decedent owned a one-half interest in Illinois farmland at the time of his death as a tenant in common, the majority of which was tillable land. The property was accessible only by one road on the eastern side of the parcel.

Based on the report of an appraiser, the estate claimed a 12.5 percent discount because of the difficulties associated with ownership as a tenant in common and the difficulty and undesirability of partitioning the property. The expert for the estate testified that it is common practice for appraisers in Illinois to discount fractional interests in real property by 20 or 25 percent for such difficulties

The Service, providing no expert testimony, argued that partitioning property would be a simple process. In the alternative, the Service argued that the property could be sold at the fair market value and the proceeds could then be subsequently distributed.

The court upheld the estate's 12.5 percent discount stating that the facts in the case provided sufficient evidence to support the claimed discount.

3. **Estate of Pillsbury v. Commissioner**
TC Memo 1992-425
Decided July 27, 1992

A marital trust for the decedent's benefit owned an undivided 77 percent interest in residential real property. The remaining 23 percent interest in the real property was held by the trustee of the same trust for the benefit of children of the decedent's spouse. The trustee of the trust for the benefit of the decedent and the trust for the benefit of the children were the same bank. The decedent's estate claimed a 15 percent fractional interest discount for both the real property and the furnishings located in the residence. The estate further claimed at trial that the discount should be increased to 20 percent.

The court rejected the Service's argument that a discount was inappropriate because 100 percent of the real property was held by the trustee bank. The court stated this unity of ownership argument is inconsistent with the willing buyer-willing seller rule and it was irrelevant that the seller is also the holder of the remaining interest in the property.

The estate's expert presented evidence that a hypothetical buyer of a 77 percent interest in real property would discount the property due to disadvantages such as lack of general of control, lack of marketability, illiquidity, and potential partitioning expenses. The estate's expert was unable to locate any comparable sales in reaching his conclusions.

The court concluded that the fair market value of a fractional interest in real property cannot be derived merely by applying the percentage of the interest in the whole property to the value of the whole property. The court determined that a 15 percent discount was appropriate for the real property.

However, the court denied the discount for the tangible personal property located at the residence because the estate did not provide any evidence in support of such discount. The court stated that "a bare assertion that a discount is appropriate, however, with no evidence to support it cannot be upheld."

4. **LeFrak v. Commissioner**
TC Memo 1993-487
Decided November 16, 1993

Mr. LeFrak gifted interests in income producing real property to his children or trusts for their benefit. Mr. LeFrak argued that the value of the gifts should be discounted because the donees received minority interests in the real property and such minority interests were not readily marketable.

The Service argued that a discount was not appropriate because the donor and donees were all members of the same family, giving a unity of interest in the control of the buildings which would obviate the need for a discount. The court quickly rejected this argument and stated that the fact that all co-owners were family members should not preclude allowance of a minority discount because it was still possible for dissension and discontent to arise in the future among the family.

The court permitted a combined lack discount of 30 percent, 20 percent for minority and 10 percent for lack of marketability.

5. **Estate of Cervin v. Commissioner**
TC Memo 1994-550
Decided October 31, 1994

At the time of his death, the decedent owned an undivided 50 percent interest in a farm and an undivided 50 percent interest in a homestead. The decedent's son and daughter owned the remaining 50 percent in the farm and homestead. The property was only partially suitable for farming, had only one access to a paved road, and could not be partitioned into two equal parcels.

The estate argued that partitioning of the farm was impossible and a 25 percent discount was appropriate. The Service argued that the property was 'ripe' for partition and the costs of such partition would result in a 6.54 percent discount for the farm and 8.20 percent for the homestead.

The court cited that the fair market value of the decedent's interest in the real property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all facts. The court refused to value the property as a whole and instead permitted a 20 percent discount. This discount was based on the expected costs of a hypothetical partitioning of the property. There would be substantial costs in partitioning this property and any partition would require an agreement among the other owners.

As to the homestead, the experts agreed that the homestead could not be partitioned. In such a situation under state law, a party may petition the court for a forced sale of the entire homestead with the proceeds to be divided among the interest holders. The experts disagreed as to the costs of such a forced sale. The court agreed that a prospective buyer of the property would require a sizeable discount.

The estate's 25 percent discount was viewed to be excessive because part of such discount included costs to repair the homestead.

6. **Estate of WIlliams v. Commissioner**
TC Memo 1998-59
Decided February 12, 1998

The decedent owned undeveloped rural timberland and farmland in Florida. Decedent's spouse leased timber rights to a paper company. Decedent transferred an undivided one-half interest in the property to Petitioner.

Petitioner presented evidence that banks would not provide loans to the owner of a fractional interest in real property without the consent of the other owner. Petitioner's expert also stated that fractional interests in the property were not marketable and no comparable sales could be identified. The Petitioner's expert applied a 44 percent discount to the undivided one-half interest in the property, combining a 30 percent discount for lack of control and a 20 percent discount for lack of marketability. Another expert for Petitioner concluded that the property could only be used for agricultural purposes.

The expert for the Service concluded that the property could be used for timber growth, agriculture, rural, residential and waterfront development purposes. No discount was applied and no evidence of an applicable discount was presented. At trial, the Service was willing to grant a 5 percent discount. The Service argued that a discount in excess of 5 percent should not apply because the Petitioner presented no evidence of actual sales of fractional interests in real property.

The court applied a 44 percent discount for the property. The court was persuaded that the inability to present evidence of actual sales of interests in real property shows that there was no market for fractional interests in such real property. The court did not limit the discount to the costs of partitioning the property. Lack of marketability and control discounts were both permitted.

7. **Estate of Stevens v. Commissioner**
TC Memo 2000-53
decided February 18, 2000

The decedent and a trust created by decedent's husband each owned a one-half interest in three pieces of commercial real property in California as tenants in common.

The Service's expert only looked to the costs of partition and other specified costs in setting an applicable discount. The Service ultimately asserted discounts of 10 percent, 10 percent and 20 percent for each respective property; however, only 3 percent to 4 percent of each amount was attributable to the costs of partition and it is not known where the additional discounts were attributable to.

The estate argued for discounts of 35 percent, 30 percent and 35 percent for each piece of property. The estate argued that the properties could not be partitioned; this argument was rejected by the court because the trust provides the Trustee the power to partition the property.

The court discussed in detail when partitioning property is a viable option. The court stated that partition is an easier option for unimproved property whereas for improved property partition is more challenging and is not as viable of an option. Where significant income producing improvements are involved, partition is even less viable.

The court was swayed by the following factors: (i) there was no control because of the 50/50 ownership structure, (ii) there were significant risks of partition, (iii) the possible high costs of partition, (iv) the delay in achieving a proper partition, (v) the lack of liquidity among the parties, (vi) the lack of marketability of the interests in the property, and (vii) the lack of obtaining adequate financing without consent of other owner.

The court cited that the fair market value of the decedent's interest in the real property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all facts.

Accordingly, the court refused to value the property as a whole and instead permitted a 25 percent discount. The court did not limit the discount to the costs of partition because such a discount does not account for factors of lack of control and marketability in the circumstances of this case (income producing property, improved property without control, etc).

8. **Estate of Forbes v. Commissioner**
TC Memo 2001-72
Decided March 23, 2001

Decedent's husband owned timberland and pecan orchards in Georgia. The real property was held in a limited partnership and was placed in a QTIP trust for the benefit of the decedent during her lifetime.

The estate presented one expert who argued for a 36 percent discount. The court held that this expert relied on faulty assumptions and had unexplained present value calculations.

The estate presented a second expert that argued for a 30 percent discount. In support, the estate's second expert stated that the 30 percent discount was appropriate because the QTIP trust's interests were minority interests. The expert further argued that the market for such interests would be restricted when taking into consideration the limited pool of potential buyers, the difficulty in finding financing, and the costs of partitioning the parcels. The expert presented evidence of past discounts ranging between 10 percent to 30 percent for fractional interests in liquidating partnerships.

The Service's expert attempted to use a comparable sales approach to determine the appropriate valuation discount. The expert was unable to locate minority interest sales in the market and presented "comparables" that suggested discounts ranging from 25 percent to 64 percent. With little explanation, the expert concluded that a 19 percent discount was appropriate. The court ignored the Service's expert report.

The court held that the estate was entitled to a 30 percent fractional interest discount for the undivided fractional interests in the real property held in the QTIP trust. The Court held stated that the expert for the discount was reasonably justified by the properties' specific characteristics, the possible interfamily conflicts and other marketability factors.

9. **Estate of Baird v. Commissioner**
416 F.3d 442, (5th Cir. 2005)
Decided July 11, 2005

Decedent husband's estate included a 14/65 interest in a trust that held timberland in Louisiana. Decedent wife died less than one year later, and her estate included a 17/65 interest in the same trust that owned the timberland.

Mr. Baird's estate filed a return claiming a 25 percent fractionalization discount in his 14/65 interest in the real property held by the trust. Mrs. Baird's estate filed a return claiming a 50 percent fractionalization discount in her 17/65 interest in the real property held by the trust. Mr. Baird's estate subsequently filed an amended estate tax return claiming a 50 percent fractionalization discount.

The Service rejected the estates' claimed discounts. Based on an appraisal report, the Service argued that the only discounts available to the estates should be the estimated costs of a hypothetical partition in kind because no reliable market comparable sales could be identified. The estimated costs were equivalent to a 3.37 percent discount for Mr. Baird's estate and a 3.11 percent discount for Mrs. Baird's estate.

Each estate subsequently increased the fractionalization discount to 60 percent and filed a claim for refund. The estate further demanded a 70 percent fractional discount at an appeals conference. Prior to trial the estates submitted expert witness reports discussing the costs, time and risks involved in a partition proceeding. The experts for the estates stated that the remaining owners of the property would object to the partition of the property, thereby making it nearly impossible to accomplish an adequate partition.

The Court held for the estates and allowed a 55 percent lack of marketability discount. The court stated that the costs of partitioning the property was only one factor in to be taken into consideration when valuing properties. The Court further held that an additional 5 percent discount was appropriate due to the potential difficulty in partitioning the property with the remaining property owners.

The Fifth Circuit also awarded attorneys fees to the estates because the Service's position for limiting the discount to the costs of the partition lacked authority.

C. CASES AND RULINGS APPROVING DISCOUNTS FOR ARTWORK.

1. Stone v. United States
103 AFTR 2d 2009-1379 (9th Cir.), decided March 24, 2009, affirming 100 AFTR 2d 2007-5512 (N.D. Cal.), decided August 10, 2007, affirming, 99 AFTR 2d 2007-2992 (N.D. Cal.), decided May 25, 2007

The decedent owned a 50 percent interest in nineteen paintings (the entire collection was valued at approximately $5 Million). The estate argued that the estate's interest in should have been valued at 28 percent of the fair market value of the collection, which would have reflected a 44 percent fractional interest discount. The Service argued that the no discount should apply and the value of the paintings were equal to 50 percent of the full fair market value of the entire collection.

The court held that a hypothetical seller who is under no compulsion to sell would not accept the 44 percent discount proposed by the estate. The court found persuasive the testimony of the Service's experts that neither had seen discounts applied in the sale of undivided interests in artwork.

The estate's expert could also find no data regarding the sales of undivided interests in artwork. The estate's expert based his valuation discount on sales data for undivided interests in real estate and limited partnerships holding real estate. However, the court found that the art market was not like the real estate market or business market and that a hypothetical owner would likely buy out the other co-owner or seek a partition action to sell and divide proceeds.

The court only applied the a cost of partition discount of 2 percent, a discount for legal fees, and a discount for the volatility in the art market during the time the painting was for sale. The court determined that a total discount of 5 percent applied after the parties failed to reach an agreement as to the overall discount.

However, the court did not entirely the foreclose the possibility for applying fractional discounts to tangible personal property. Citing Pillsbury v. Commissioner, 64 T.C.M. 284 (1992), the stated that discounts for tangible personal property can be upheld provided there is not a “bare assertion that a discount is appropriate with no evidence to support it.” Further, the court cited the Propstra decision and stated that discounts for real or tangible property may be appropriate if the holder of an undivided interest in property would have to secure the consent of the other owners before being able to sell as a unit.

2. **Blockage Discount Cases for Artwork**.

Smith v. Commissioner
57 TC 650
Decided February 23, 1972

Calder v. Commissioner
85 TC 713
Decided November 6, 1985

O’Keeffe v. Commissioner
TC Memo 1992-210
Decided April 8, 1992

In each of the above cases, the decedents were well known artists. Each of the estates applied blockage discount to the value of the artwork owned in the estate at the time of the decedent’s death. The estates argued that a blockage discount was appropriate due to the large number of pieces of artwork owned in the estate at the time of the decedent’s death and the relative smaller market that could absorb such artwork. Each court ultimately upheld the requested blockage discount.

D. **CHART SUMMARIZING DISCOUNTS.**

Case/Decision	Type of Property	Discount Applied	Limited to Costs of Partition?
TAM 199943003	Real Property	N/A	Yes
PLR 9336002	Real Property	N/A	Yes
Pillsbury v. Commissioner	Real Property	15%	No
LeFrak v. Commissioner	Real Property	30%	No
Cervin v. Commissioner	Real Property	20%	No
Williams v. Commissioner	Real Property	44%	No
Stevens v. Commissioner	Real Property	25%	No
Propstra v. U.S.	Real Property	15%	No
Forbes v. Commissioner	Real Property	30%	No
Baird v. Commissioner	Real Property	55%	No
Youle v. Commissioner	Real Property	12.5%	No
Stone v. Commissioner	Artwork	5%	Yes

III. TIC VS. FLP ANALYSIS.[51]

A. PROS/CONS.

1. **Simplicity**. Tenancies in common are the hands down winner in this category. In a family situation where there is little concern about disputes over management of a piece of property, tenancies in common are ideal and require a quit claim deed to implement this strategy.

An FLP on the other hand requires a great deal more in care and feeding than a tenancy in common. Indeed if the business formalities are not maintained with the FLP then the

[51] Part III of the outline was prepared by Hugh F. Drake of Brown, Hay & Stephens, LLP, Springfield, Illinois.

benefits afforded through discounts could be invalidated, not to mention the loss of the liability shield.

2. **Liability**. The nature of tenancy in common is that each co-owner of real property owns an undivided interest in the whole property. Accordingly, each co-owner has a right to use and enjoy the whole property. This brings with it unlimited liability for each co-owner as well. A creditor of any of the individual co-owners may enforce their rights against the property and consequently the interests of all the other co-owners.

The liability exposure in tenancies in common can be mitigated to some degree through the use of a tenancy in common agreement, which would hold that the various co-owners must indemnify one another to the extent of that owner's interest. Accordingly, a co-tenant with a 25% interest in TIC property would agree to indemnify the other co-tenants up to 25% of the liabilities incurred by the whole tenancy in common.

Another means of addressing liability would be for a co-tenant to hold his interest in a single asset limited liability entity. Individuals and entities with multiple assets in addition to tenancy in common interests may be exposing themselves to much more liability than is necessary through their tenancy in common interest. Something like a single-asset LLC holding the tenancy in common interest could assist in limiting that exposure.

However, once you start employing tenancy in common agreements and LLCs to hold tenants in common interests, you may be beyond the value of the tenancy in common in its simplicity. If you were to engage in a complicated tenancy in common agreement or LLC to hold your interest, then why not just implement an FLP or an FLLC to hold the property at that?

3. **Discounts**. The chart above summarizes the discounts seen in tenancy in common cases, with a range of 15-55% for real property interests. While this range would be comparable with FLP discounts, it is likely that across the board discounts would tend to be slightly less than that of FLPs. Of course when considered with the measure of simplicity and ease of administration, achieving the discounts that are available through tenancies in common might be an easy call.

4. **Scrutiny**. It may be because of their simplicity. It may simply be due to unfair perceptions. Whatever the reason, tenancies in common and tenancy in common discounts are likely less of a target for audit from the Service.

Many of the arguments levied against FLPs would not be available to the Service in the tenancy in common context.

In the family context, tenancies in common shouldn't involve the business purpose doctrine because it isn't a business or investment transaction. Converting property from joint tenancy with rights of survivorship to a tenancy in common should be considered appropriate to facilitate the disposition of spouses separate interest upon the death of the co-tenants. Further, the gift of tenancy in common interests to family members provides an undivided interest in the asset with disposing of the whole asset.

The economic substance doctrine won't apply in the creation of a tenancy in common because the interests and powers are actually changed. If the parties act in accordance with the changes in their ownership interest, there should be no concern for lack of economic substance.

Section 2036, dealing with a decedent's transfer of interest while retaining a life estate, which has been a stalwart of the Service's attacks on FLPs, won't apply to the creation of a tenancy in common. Absent a tenancy in common agreement which potentially could restrict and allow rights among the co-tenants in such a way to implicate 2036 or some pattern in practice which runs contrary to the form of ownership, a tenancy in common existing under bare state law could hardly be characterized as a life estate. While one co-tenant may have, in some respect, retained the possession and enjoyment of the property, it is not to the exclusion of the possession and enjoyment of the whole property by any one of the other co-tenants. Further, the income of any one co-tenant would be limited to that co-tenant's proportionate share of the whole property.

Section 2703 could be implicated in a tenancy in common with an agreement that attempts to limit the rights of the parties to sever the interests in a manner that is more restrictive than state law. If that is the case, Section 2703 would likely ignore the restrictions as set forth in the agreement, upon which the worst case scenario would be that the state law restrictions would apply.

5. **Partition**. The prospect of a partition definitely detracts from the luster of tenancy in common planning. Partition means the division of land held in co-tenancy into the co-tenants' respective fractional shares. If a court finds the land cannot be fairly divided, then the estate is sold and the sale proceeds divided based upon pro rata shares. Every co-tenant has the right to compel partition, no matter how small of a fractional interest held, but that right may be modified or eliminated by a tenancy in common agreement.

Barring a tenancy in common agreement, the right to partition is virtually unconditional. Partition in kind (by physical division) is the preferred method of partition unless the co-tenants agree to a partition sale or a physical division is impossible to implement equitably. If partitioning in kind produces inequalities among the owners, the court may award monetary payments to offset the differences. If a sale of the property and division of the proceeds is more equitable, all jurisdictions permit partition by sale and division of the proceeds.

Every partition action includes a final accounting for both charges and credits upon each co-tenant's interest. Charges include received rents and profits beyond the co-tenants fractional share, fair rental value of the entire tenancy in common if the co-tenant has excluded the others, and waste committed by the co-tenant. Credits include expenditures in excess of the co-tenants fractional share for necessary repairs, improvements that enhance the value of the property, taxes, payments of principal and interest on mortgages and other liens, insurance for the common benefit, and amounts expended in protecting and preserving title.

Partition actions are typically emotional and contentious, costing a great deal in attorneys fees to engage in such a battle.

6. **Control**. The FLP is more attractive in terms of control, at least if compared to a tenancy in common where no agreement has been implemented. In the absence of a tenancy in common agreement, each co-tenant has the use and enjoyment of the whole. By virtue of that, unanimity is required in all decision making. This leaves an inordinate amount of power in even minor fractional interest holders, who hold have veto authority over every decision.

The RPTE Section implemented a task force to address concerns surrounding tenants in common property, and what is often referred to as "heirs' property." A common scenario is where the ownership of property will devolve through generations by intestacy. The interests will then become more and more fractionalized, yet with each minor interest holder wielding a great deal of power over the whole. In areas where the real property becomes prized for development, a recent phenomenon shows developers purchasing the interest of one of the fractional interest holders and thereby securing the ability to force a partition and perhaps a fire sale. The developer then stands to purchase the property at auction at a fraction of the cost. In situations where the families who have owned the ground for generations lack the resources to mount a legal challenge to these tactics, tenancy in common ownership poses a real threat to family farms. For more information on the RPTE Property Preservation Task Force, please see the RPTE website (http://www.abanet.org/dch/committee.cfm?com=RP018700).

7. **Asset Availability**. There is little authority available that permits tenancy in common discounts for assets other than real property. For FLPs, discounts are generally applied to the partnership interests, not the underlying property. Therefore, FLPs appear to be more appropriate to generate discounts for assets other than real property.

B. IDEAL TIME TO USE TENANCIES IN COMMON.

1. Family.

2. Relatively few individuals.

3. Clients who are risk adverse.

4. Clients who perceive FLPs as too complex.

5. Liability not a paramount concern.

6. Clients unable or unwilling to pay costs associated with more involved planning.

7. Clients with timing issues.

IV. **TENANCY IN COMMON AGREEMENT**.[52]

A. **USE OF TENANCY IN COMMON AGREEMENTS**.

There is a great deal of variation and uncertainty that exists among state partition laws. To provide some measure of control, a common practice among co-tenancy real estate owners is to use tenancy-in-common agreements. This practice has been approved by Service Rev. Proc. 2002-22, discussed in more detail below, which establishes for federal tax purposes the basis upon which the Service will not characterize a tenancy-in-common agreement as a partnership.

A sample of a tenancy in common agreement is provided below. The elements that are common among such are agreements are as follows:

1. Specifies a term of the agreement.

2. Authorizes an individual or entity, such as a limited liability company, to manage the property.

3. Provides for additional operating capital to be supplied from the owners to operate, improve or otherwise manage the property.

4. Provides that if one of the co-tenants defaults on the agreement, the non-defaulting owner may elect to pay the defaulting owner's share, in which case, the non-defaulting owner shall be entitled to a percentage of the defaulting owner's interest.

5. Authorizes a co-tenant to sell or exchange his interest in the property but only after first offering to sell such property to the other co-tenants.

6. Limits the right to partition the property by requiring a co-tenant to first offer to sell his interest to the other co-tenants governed by an MAI appraisal. In the event the non-selling co-tenants decide to name their own appraiser, they may do so and those two appraisers may identify a third appraiser to appraise the property.

7. Expressly states that the parties do not intend to become partners under the agreement.

[52] Part IV of the outline was prepared by Hugh F. Drake of Brown, Hay & Stephens, LLP, Springfield, Illinois.

B. **TENANCY IN COMMON AGREEMENT – FORM**.

This Tenancy in Common Agreement is entered into this ____ day of __________, 2009 by and between ____________________ and _________________________________ referred to herein collectively as "Owners" and individually as "Owner".

RECITALS

WHEREAS, Owners have, simultaneously with the execution hereof, acquired a ________% undivided interest and a _________% undivided interest respectively, as tenants-in-common, in and to that certain real property described generally as ___________________________ (the "Property") as more particularly described on Exhibit "A" attached hereto; and

WHEREAS, the Owners shall own their respective interests in the Property as tenants in common, subject to the terms, covenants and conditions set forth below, which terms are necessary to ensure the proper and orderly management and operation of the Property during the period of the Owners' co-ownership.

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree as follows:

AGREEMENTS

Section 1. Term

This Agreement shall be in place until such time as it is terminated by (i) sale of the Property by the Owners; or (ii) terminated by the agreement of both parties.

Section 2. Management

____________ and ____________ shall execute a Management Agreement naming ____________, ("Manager") as manager of the Property, to handle such matters as the lease, operation and maintenance of the Property as more fully set forth in said agreement, a copy of which is attached hereto as Exhibit "B".

Section 3. Operating Capital

a. In the event Manager determines, from time to time, that additional capital from the Owners is required to operate, improve, or otherwise manage the Property, it shall so notify the Owners, in writing, of the total additional sum required, and request that Owners submit such total, within ten (10) days after receipt of said written notice.

b. The failure of any Owner to make such additional contribution within ten (10) days after receipt of notice requesting same shall constitute a material breach of this Agreement and the non-contributing Owner shall be considered in default hereunder. The amount of any delinquent additional contribution plus interest at the prime rate as published from time to time in the Wall Street Journal plus three (3%) percent, shall be offset against any further *distributions due the defaulting Owner.*

c. The non-defaulting Owner shall have the right, but not the obligation, to pay the defaulting Owner's pro rata share of such additional contribution. The non-defaulting Owner so electing to pay the defaulting Owner's share shall be entitled to a percentage of the defaulting Owner's interest. A portion of the defaulting Owner's interest shall be transferred to the non-defaulting Owner who has made said payment under the following formula: the percentage of the defaulting Owner's interest that will be transferred to the non-defaulting Owner shall be the quotient wherein the dividend is the amount paid by the non-defaulting Owner and the divisor is the current amount of all sums paid, to date, by the defaulting Owner for the purchase or operation of the Property. For example, if the amount paid by the non-defaulting Owner is $10,000.00 and the current total sums paid by the defaulting Owner for the purchase and operation of the Property is $200,000.00, then five (5%) percent of the defaulting Owner's interest will be transferred to the non-defaulting Owner. The defaulting Owner shall have a period of sixty (60) days from the date of said payment to redeem its interest from the non-defaulting Owner by paying to said non-defaulting Owner the amount of the funds advanced by the non-defaulting Owner together with interest thereon at the Wall Street Journal prime rate plus three (3%) percent.

Section 4. Sale/Partition and Right of First Refusal

a. Sale of the Property. Either Owner shall have the right to sell, exchange or otherwise transfer its interest in the Property, or any part thereof, after having first offered to sell said interest to the other Owner in accordance with the following procedure:

(i) The interest in the Property which the transferring Owner intends to sell, exchange or otherwise transfer shall first be offered in writing to the other Owner at the stated price at which the interest is proposed to be sold to a third party. The other Owner shall have a period of thirty (30) days after receipt of such notice in which to accept or reject said offer, in writing.

(ii) In the event the non-transferring Owner rejects the offer, then the transferring Owner shall be free to sell its interest in the Property on the terms set forth in the notice and on no other terms. In the event the non-transferring Owner accepts the offer, then the non-transferring Owner shall purchase the interest of the transferring Owner on the terms set forth in said notice within sixty (60) days after the acceptance of said offer. The selling Owner shall pay any and all title insurance premiums and reasonable closing costs associated with said transfer.

b. Partition of the Property. Either Owner shall have the right to partition the Property, after having first offered to sell his interest therein to the other Owner in accordance with the following procedure:

(i) The Owner desiring to partition the Property shall notify the other Owner, in writing, of such desire. In such notice, the Owner seeking partition shall name an MAI appraiser active in _____________.

(ii) The non-partitioning Owner shall have ten days to consent to such appraiser, or identify another MAI appraiser active in _____________. Failure to submit an alternative appraiser's name within said ten day period shall be deemed consent to the initial named

appraiser. If the non-partitioning Owner identifies a second appraiser, then the two identified appraisers shall promptly designate a third MAI appraiser to appraise the Property. The partitioning Owner shall pay the cost of an appraisal of the Property conducted by the designated or agreed appraiser. Within five days after receipt of the appraisal report, and prior to the initiation of any partition action, the partitioning Owner shall offer to sell his interest in the Property to the non-partitioning Owner, in writing, at a discounted price equal to (1) the Property's appraised value, times (2) the partitioning Owner's percentage ownership interest in the Property, times (3) .75. The other Owner shall have a period of thirty (30) days after receipt of such written offer in which to accept or reject said offer, in writing. Failure to follow the procedures set forth in this section shall constitute a complete defense to any partition action brought by any Owner.

(iii) In the event the non-partitioning Owner rejects the offer, then the partitioning Owner shall be free to initiate a partition action in the appropriate court. In the event the non-partitioning Owner accepts the offer, then the non-partitioning Owner shall purchase the interest of the other Owner at the price set forth in said notice within one hundred twenty (120) days after the acceptance of said offer. The selling Owner shall pay any and all title insurance premiums and reasonable closing costs associated with said transfer. The parties acknowledge and agree that, in the event of default under the terms of this Agreement by either Owner, the non-defaulting Owner shall have the right to seek specific performance of the terms of the Agreement by the defaulting Owner and money damages.

Section 5. Status of Relationship

The parties acknowledge that it is their intention to hold the Property as tenants in common and that they have expressly elected not to become partners and that neither this Agreement nor any provision of this Agreement shall be interpreted to impose a partnership relationship at either law or equity on the parties. Accordingly, no Owner shall have any liability for the debt or obligation of any other Owner. This Agreement shall not convert our interests in the property into anything other than tenancy-in-common interests in the property.

Section 6. Miscellaneous

a. Notice. Any notice required or desired to be given under this Agreement shall be deemed given, if in writing and hand delivered or sent by United States certified mail, to the other party at the address shown for said party below:

To:

To:

b. No Owner may encumber any interest in the Property.

c. This Agreement may be executed in counterparts, each of which will be deemed to be *an original and all of which together will constitute one and the same instrument.*

d. This Agreement constitutes the parties' entire agreement with respect to this transaction, and supersedes any prior oral or written understandings or agreements. The Agreement may be amended only in writing.

e. This Agreement is binding on and enforceable by and against to successors, legal representatives and assigns of the Owners. No transfer of an interest in the Property to any other person or entity may be validly completed unless the transferee agrees in writing to be bound by the terms and conditions of this Agreement.

f. This Agreement is entered into in the State of _____________ *shall be governed in all respects by the laws of such State.*

IN WITNESS WHEREOF, the undersigned have set their hands and seals on the date and year first above written.

*By:*____

Date: ____________________

*By:*____

Date: ____________________

C. **IRS REV. PROC. 2002-22**.

Prompted by the flourishing tenancy-in-common industry, the Service issued Rev. Proc. 2002-22, identifying the basis upon which the Service will issue rulings about whether a co-tenancy relationship is or is not a partnership. It is also critical to confirm that the rules applicable to the local jurisdiction do not create a partnership by default. Once a tenancy in common agreement has been implemented, a garden variety tenancy in common begins to look much more like a partnership.

Rev. Proc. 2002-22 contains the following conditions for a ruling to determine that property is not held as a partnership:

1. The number of co-tenants must be limited to no more than 35 persons. All persons who acquire interest from a co-tenant by inheritance are treated as a single person.

2. Co-tenancy may not file a partnership or corporate tax return, or execute a business entity agreement.

3. Co-tenants may enter into a limited co-tenancy agreement that runs with the land which provides that a co-tenant must offer the co-tenant interest for sale to the other co-tenants or the sponsor before exercising any right to partition, or that certain actions on behalf of the co-tenancy require the co-tenants holding more than 50% of the undivided interest in the property.

4. The co-tenants must retain the right to approve the hiring of any manager, sale or other disposition of the property, in leases of a portion or all of the property, or the creation or modification of a blanket lien. Any sale, lease or release of a portion or all of the property in a negotiation or re-negotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract must be by unanimous approval of the co-tenants. For all other actions on behalf of the co-tenants, the co-tenants may agree to be bound by the vote of those holding more than 50% of the undivided interest in the property. Individual limited powers of attorney in favor of the co-tenants are not permitted but a co-tenant may not provide a manager or other person with a global power of attorney.

5. Each co-tenant must have the right to transfer, partition and encumber the co-tenant's undivided interest in the property without the agreement or approval of any person. The co-tenants, the sponsor or the lessee may have a right of "first offer," i.e. the right to have the first opportunity to offer to purchase the co-tenant interest (with respect to any co-tenant's exercise of the right to transfer the co-tenant interest in the property. In addition, the co-tenant may agree to offer the co-tenancy interest for sale to the other co-tenants, the sponsor or the lessee at fair market value, determined either at the time the partition right is exercised, before exercising any right to partition.

6. If the property is sold, any debt secured by blanket lien must be satisfied and the remaining sales proceeds must be distributed pro rata to the co-tenants.

7. Each co-tenant must share in all revenues generated by the property and all costs associated with the property in proportion to the co-tenants undivided interest in the property. Neither the co-tenants nor the sponsor nor the manager may advance funds to a co-tenant to meet expenses associated with the co-tenancy interest, unless the advance is recourse to the co-tenant for a period not exceeding 31 days.

8. The co-tenants must share in any indebtedness secured by a blanket lien in proportion to their undivided interest.

9. A co-tenant may issue an option to purchase the co-tenant's undivided interest (a call option), provided that the exercise price for the call option reflects the fair market value of the property determined at the time the option is exercised. For this purpose, fair market value of an undivided interest in the property is equal to the co-tenant's percentage interest in the property multiplied by the fair market value of the property as a whole. A co-tenant may not acquire an option to sell the co-tenant's undivided interest (a put option) to the sponsor, the lessee, another co-tenant, or the lender or any person related to the sponsor, lessee, other co-tenant, or lender.

10. The co-tenants activity must be limited to those customarily performed in connection with the maintenance and care of rental property.

11. The co-tenants may enter into a management or brokerage agreement which must be renewable no less frequently than annually with an agent who may be the sponsor or co-tenant but who may not be a lessee. The manager must disburse to the co-tenants their shares within three months of the date of receive of those revenues. The management agreement may authorize the manager to prepare statements for the co-tenants showing their shares of revenue and costs from the property. It may also authorize the manager to obtain and modify insurance on the property and to negotiate modifications of the terms of any lease or indebtedness encumbering the property subject to the approval of the co-tenants. The determination of any fees paid by the co-tenancy to the manager must not depend in full or in part on the income or profits derived by any person from the property and may not exceed the fair market value of the manager's services; any fee paid by the co-tenancy to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

12. Leasing agreements must be bone fide leases for federal tax purposes and rents paid by a lessee must reflect the fair market value for the use of the property. The determination of the amount of the rent must not depend in whole or in part on the income of profits derived by any person from the property leased. The amount of rent paid by lessee may not be based on a percentage of net income from the property cash flow, increases in equity or similar arrangements.

13. The lender, with respect to any debt that encumbers the property or with respect to any debt incurred to acquire an undivided interest in the property, may not be a related person to any co-tenant, the sponsor, the manager, or the lessee of the property.

14. The amount of any payment to the sponsor for the acquisition of the co-tenancy interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-tenancy interest (or for services rendered) and may not depend, in whole or in part, on the income of profits derived by any person from the property.