WHAT'S HOT AND WHAT'S NOT
-- CURRENT VALUATION ISSUES
INVOLVING CLOSELY HELD INTERESTS

18TH ANNUAL REAL PROPERTY AND ESTATE PLANNING SYMPOSIA

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I. OVERVIEW.

The determination of the fair market value of an interest in property which is being transferred, either by gift or at death, is the foundation upon which our federal estate and gift tax system is built. The United States Supreme Court has often held that succession taxes, inheritance taxes and estate taxes are constitutional levies by the federal government only if they are applied in a manner that merely is an excise tax at the transfer of property at death. *See, e.g.*, *Knowlton v. Moore*, 178 U.S. 41 (1900); *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921). Therefore, only that property which is transferred as a result of a taxpayer's death or by gift during the taxpayer's life can be subjected to taxation under the federal estate and gift tax system. The tax cannot be a "wealth tax" or "property tax" on the intrinsic value of an asset to the decedent or donor at the time the transfer occurs; rather, it must be a tax on the value of the asset transferred. *See* I.R.C. §§ 2033, 2035-38, 2040(c), 2044 and 2501.

II. BASIC VALUATION PRINCIPLES.

In determining the value of any asset that is transferred, the legal rights and interests inherent in that property must first be determined under state law (unless federal law supersedes state law). After that determination is made, federal tax law takes over to determine how such rights and interests will be taxed. *United States v. Bess,* 357 U.S. 51 (1958); *Morgan v. Comm'r*, 309 U.S. 78 (1940); *Estate of Nowell v. Comm'r*, 77 T.C.M. (CCH) 1239 (1999) (Cohen, C.J.). The valuation of property for transfer tax purposes is based upon the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b); Treas. Reg. § 20.2512-1. "The standard is an objective test using hypothetical buyers and sellers in the marketplace, and is a not personalized one which envisions a particular buyer and seller." *LeFrak v. Comm'r*, 66 T.C.M. 1297, 1299 (1993). "All relevant facts and elements of value as of the applicable valuation date shall be considered in every case." Treas. Reg. § 20.2031-1(b).

Because of this test, there are two primary components of federal estate and gift tax valuation: 2(1) understanding the state law rights being transferred from the hypothetical willing seller to the hypothetical willing buyer, and (2) determining the fair market value of the transferred rights.

III. FAMILY LIMITED PARTNERSHIP ISSUES - Dealing with the IRS's Arguments Regarding Family Limited Partnerships.

Beginning in early 1997, the Internal Revenue Service, through the issuance of technical advice memoranda and private letter rulings, embarked on a frontal assault on the use of family limited partnerships and other closely held entities for estate planning purposes. In these pronouncements, the National Office of the Internal Revenue Service took the position that an entity be completely disregarded for estate and gift tax purposes under various theories, whether or not that entity was validly created and existing under state law. *See, e.g.*, PLR 9736004 (June 6, 1997); PLR 9735043 (June 3, 1997); PLR 9735003 (May 8, 1997); PLR 973004 (April 3, 1997); PLR 9725018 (March 20, 1997); PLR 9725002 (March 3, 1997); and PLR 9723009 (February 24, 1997).

A. The Murphy Argument.

The principal support for the National Office's position in each of its pronouncements comes from the Tax Court's memorandum decision in *Estate of Murphy v. Comm'r*, 60 T.C.M. (CCH) 645 (1990), in which the Court valued a decedent's 49.65% common stock interest in a closely held corporation as a controlling interest because the decedent had given her children a 1.76% block of stock only 18 days before her death. The Court specifically found that "all concerned intended nothing of substance to change between the time of transfer and the time of [the decedent's] death, and that nothing of substance did change." *Id*. at 659. The Court stated that its position was "consistent with the established principle that transactions with no purpose or effect other than to reduce taxes are disregarded for federal tax purposes." *Id*. (emphasis added) Relying on this language in Murphy, the IRS argues that if the primary purpose for creating the partnership was to reduce transfer taxes, the IRS can ignore it for tax purposes.

The IRS relies on the *Estate of Murphy v. Comm'r*, 60 T.C.M. (CCH) 645 (1990) for the proposition that should the formation of the entity (FLP) be intended primarily for tax reduction purposes, then the entity can be ignored for Federal tax purposes. Murphy says no such thing. The question in *Murphy* was whether a gift of corporate stock 18 days before Mrs. Murphy's death should be recognized for estate tax purposes when the undisputed facts demonstrated that the "sole motive" for the transaction was to obtain the minority interest discount for the remaining 49% stock owned by Mrs. Murphy at the time of her death. The Court in *Murphy* said because the "sole motive" for the transaction was to tax reduction, and that nothing of substance changed in connection with the transaction, it could be ignored for a transfer in tax purposes.[1] Even if *Estate of Murphy* can be characterized to allow the IRS to disregard the existence of an entity (there is substantial doubt that the holding can be extended that far in light of the fundamental principles of transfer tax law discussed above and the Fifth Circuit's holding in *Wheeler* discussed below), *Murphy* does not allow the IRS to disregard the existence of a validity created entity under state law for transfer tax purposes where valid non-tax reasons for creating the entity exist. In other words, *Murphy* is a case where the sole motive for the transaction was transfer tax savings. Contrary to the Service's position, "taxpayers generally are free to structure a business transaction as they please, even if motivated by tax avoidance considerations." *Kerr v. Comm'r*, 113 T.C. 449, 464 (1999).

Established judicial authority holds that the Service cannot disregard the existence of a partnership if the partnership was formed for a business, financial, *or* investment reason or in fact did engage in a business, financial, or investment activity.[2] Where any of these tests has been met, the courts have not ignored the effect of partnership agreements on valuation, even

[1] Ironically, the National Office pronouncements virtually ignore the Tax Court's memorandum decision in *Estate of Frank v. Comm'r*, 69 T.C.M. (CCH) 2255 (1995), which involved facts substantially similar to *Murphy*. In addressing a fact situation similar to that in *Murphy*, the Tax Court held that "as a general rule, we will respect the form of the transaction. We will not apply substance over form principles unless the circumstances so warrant." *Id.* at 2259.

[2] *See Frank Lyon Co. v. U.S.*, 435 U.S. 561, 583-584 (1978); *Estate of McLendon v. Comm'r*, 66 T.C.M. (CCH) 946, 962 (1993); *Sparks Farm, Inc. v. Comm'r*, 56 T.C.M. (CCH) 464, 472-473 (1988); *Estate of Harrison v. Comm'r*, 52 T.C.M. (CCH) 1306, 1309 (1987); *Estate of Bischoff v. Comm'r*, 69 T.C. 32, 39-41 (1977).

when valuation discounts approach 85%.[3] Moreover, the "intent" based argument asserted by the IRS under its *Murphy* analysis is similar to the argument expressly rejected by the Fifth Circuit in *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997). In *Wheeler*, the Government argued, in connection with a purchase of a remainder interest in a trust, that "because the purpose of § 2036(a) is to reach intrafamily interest transfers that amount to testamentary substitutes and include the underlying asset's value in the gross estate, the adequate and full consideration for intrafamily transfers—which are generally testamentary in nature because the interest passes 'to the natural objects of one's bounty in the next generation'—must be measured against the entire value of the underlying asset in order to accomplish § 2036(a)'s purpose." *Id.* at 764. The Fifth Circuit rejected the Government's argument, stating that "[i]t is safe to say that, with the possible exception of gifts *causa mortis*, the present transfer tax scheme eschews subjective intent determinations in favor of the objective requirements set forth in the statutes . . . Unless and until the Congress declares that intrafamily transfers are to be treated differently, *see* I.R.C. §§ 2701-2704 (West Supp. 1996) discussed below, we must rely on the objective criteria set forth in the statute and Treasury Regulations to determine whether a sale comes within the ambit of the exception to Section 2036(a)." *Id*. at 765-766. *See also Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000) (Ignoring the subjective intent of the parties in creating the partnership, the Court stated that "the partnership had sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent's assets, and we will not do so in this case." *Id.* at 486.).

B. I.R.C. § 2703 Argument.

1. I.R.C. § 2703 Cannot Be Used to Completely Ignore the Existence of a Partnership Validly Created and Existing Under State Law.

In each of the National Office pronouncements, the Service took the position that I.R.C. § 2703 allows the IRS to disregard the existence of a partnership under the theory that the partnership agreement is a "restriction on the right to sell or use" the property of the partnership which can be ignored under I.R.C. § 2703 unless it meets the safe harbor provisions of I.R.C. § 2703(b). In essence, the Service interprets the word "property" in I.R.C. § 2703 to mean the assets transferred to the partnership -- not the partnership interest transferred.

The Service has stated that I.R.C. § 2703 can be used to completely disregard the existence of a partnership validly created and existing under state law. This argument ignores the fact, however, that the transfer tax is a tax on the "transfer of property." In essence, the Service claims that the property "transferred" is the transferor's interest in the property of the partnership, and that the value of the "interest" for transfer tax purposes is the transferor's proportionate share of the assets of the partnership. In the context of a decedent's estate, the question of law is whether the term "property," as it is used in I.R.C. § 2033, Treas. Reg. § 20.2031-1(b), and I.R.C. § 2703, refers to the property owned and transferred by a decedent as a result of his death (an interest in a partnership validly created and existing under state law and federal tax law) or, as the Service contends, to property that was not owned or transferred by the

[3] *See Estate of Watts v. Comm'r*, 51 T.C.M. (CCH) 60 (1985), *aff'd*, 823 F.2d 483 (11th Cir. 1987); *John R. Moore v. Comm'r*, 62 T.C.M. (CCH) 1128 (1991); *Estate of Harrison v. Comm'r*, 52 T.C.M. (CCH) 1306 (1987); *Harwood v. Comm'r*, 82 T.C. 239 (1984).

decedent as a result of his death (the property owned by the Partnership)? To determine this issue, the fact-finder will need to determine (1) whether the term "property," as it is used in I.R.C. § 2033 and Treas. Reg. § 20.2031-1(b), means the decedent's partnership interest; and (2) whether the term "property," as it is used in I.R.C. § 2703, has the same meaning as the term "property" as it is used in I.R.C. § 2033 and Treas. Reg. § 20.2031-1(b).[4]

A partnership interest is included in a decedent's estate for estate tax purposes because of I.R.C. § 2033. Under that section, "[t]he value of the gross estate shall include the value of all *property to extent of the interest therein of the decedent* at the time of his death." I.R.C. § 2033 (emphasis added). As a general rule, "the value of *every item of property* includable in a decedent's gross estate under §§ 2031 through 2044 [of the Code] is its fair market value at the time of a decedent's death . . . The fair market value is the price at which *the property* would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b) (emphasis added).

I.R.C. § 2703 addresses the value of certain property included in a decedent's estate under I.R.C. § 2033; it does not attempt to change the property interest being included. In certain instances, however, I.R.C. § 2703 can exclude from consideration for valuation purposes what would otherwise be relevant facts under the "willing buyer-willing seller" test for valuing that property by allowing certain restrictions against the transfer or use of that property, which a hypothetical buyer and seller would otherwise take into account in valuing that property. In no event does I.R.C. § 2703 permit the Service to completely ignore what property is being transferred by the decedent under I.R.C. § 2033. Specifically, I.R.C. § 2703 provides that:

> **Sec. 2703. Certain Rights and Restrictions Disregarded.**
>
> (a) GENERAL RULE--For purposes of this subtitle, the value of *any property* shall be determined without regard to--
>
> (1) any option, agreement, or other right to acquire or use *the property* at a price less than the fair market value of *the property* (without regard to such option, agreement, or right), or
>
> (2) any restriction on the right to sell or use *such property*.
>
> (b) EXCEPTIONS--Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:
>
> (1) It is a bona fide business arrangement.
>
> (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

[4] The question is similar in the context of a gift. I.R.C. § 2501, 2512 and Treas. Reg. § 2512-1 are simply substituted for I.R.C. § 2033 and Treas. Reg. § 20.2031-1(b). For simplicity, the discussion below will relate to a decedent's estate, except where noted.

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

I.R.C. § 2703 (emphasis added).

In its pronouncements, the Service appears to read the word "property" in I.R.C. § 2033, Treas. Reg. § 2031-1(b), and I.R.C. § 2703 to mean the proportionate share of the property owned by the partnership that an owner of the partnership interest would receive if the partnership liquidated. This interpretation ignores not only all terms of the partnership agreement, but the very existence of the partnership under state and federal tax law. The Service's interpretation is incorrect, for under state law a decedent generally has no right to property of the partnership and no ability to transfer property owned by the partnership. *See, e.g.*, TEX. REV. CIV. STAT. ANN. art. 6132a-1 sec. 7.01 (Vernon Supp. 1997 2004) ("A partner has no interest in specific limited partnership property."). In other words, the "property" being transferred by the decedent as a result of his death is not and cannot be the property of the Partnership; rather, the property being transferred as a result of death is the decedent's partnership interest. *Id*. Accordingly, the "property" to be valued in the decedent's gross estate is his interest in the Partnership. That is precisely what the Tax Court held in *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part on other grounds* 293 F.3d 279 (5th Cir. 2002) (where the legal interest transferred by the decedent is an interest in a partnership, and not the assets of the partnership, I.R.C. § 2703 cannot be used to disregard the existence of the entity). *See also Church v. United States*, 85 A.F.T.R.2d (RIA) 804 (W.D. Tex. 2000), aff'd without published opinion, 268 F.3d 1063 (5th Cir. 2001) (per curiam), unpublished opinion available at 88 A.F.T.R.2d 2001-5352 (5th Cir. 2001).[5]

2. I.R.C. § 2703 Can Effect the Value of the Interest Transferred.

In *Estate of Blount v. Comm'r, T.C. Memo 2004-116 (May 12, 2004)* the Tax Court addressed the question of whether the redemption price in a modified buy-sell agreement controlled the value of a decedent's closely-held stock for federal estate tax purposes. The decedent ("D") and his brother-in-law each owned 50% of the outstanding shares of stock in a construction company. In 1981, D, his brother-in-law, and the company entered into an agreement that restricted transfers of the company stock during both the shareholder's lifetimes and at death. The agreement required the company to buy a deceased's stockholder stock at an established price. Unless redetermined by the parties to the agreement, the purchase price would be equal to book value. In 1992, the company created an ESOP. The ESOP later became a third minority shareholder. After the redemption of the brother-in-law's shares following his death in January 1996, D's shares constituted a controlling 83.2% interest in the company.

In 1996 (without obtaining the ESOP's consent), D and the company modified the agreement, changing the price and terms under which the company would redeem D's shares at

[5] An examination of the other estate tax "inclusion" provisions of the Code also demonstrates that the term "property" as used in I.R.C. § 2703 means the property owned by the decedent. *See, e.g*. I.R.C. § 2034 ("The value of the gross estate shall include the value of all property to the extent of any interest therein of the surviving spouse . . ."); I.R.C. § 2035 ("[t]he value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has made a transfer . . .").

death, but leaving unchanged the provisions requiring the consent of other shareholders for lifetime transfers. The modified price was substantially below the price that would have been payable pursuant to the unmodified agreement. D died, and the company redeemed his shares pursuant to the modified agreement. D's estate reported the value of the shares held by D at death as equal to the price as set forth in the modified agreement.

The Court found that the restrictions in the modified buy-sell agreement were not binding on D during his lifetime because D, as the controlling shareholder, had the unilateral ability to amend the agreement. Therefore, under pre- § 2703 law, the agreement was disregarded for purposes of valuing the stock. In addition, the Court concluded that the agreement was subject to § 2703 because the modification significantly altered the rights of the parties with respect to the stock. The agreement did not fall within § 2703(b) because the Estate failed to show that the modified agreement was comparable to similar arrangements entered into by persons in an arm's length transaction. The only evidence offered by the Estate on the issue was testimony and the expert report of the Estate's valuation expert, who testified that the terms of the modified agreement were comparable to similar arrangements entered into at arm's length because the price provided for in the agreement for D's shares was fair market value. The Court rejected this testimony, noting that the expert "did not present evidence of other buy-sell agreements or similar arrangements . . . actually entered into by persons at arm's length. Nor did he attempt to establish that the method decedent used to arrive at his $4 million price was similar to the method employed by unrelated parties acting at arm's length." Thus, the Court held that the modified agreement was disregarded under § 2703 in valuing D's stock.

C. I.R.C. § 2704(b).

Under I.R.C. § 2704(b), certain "applicable restrictions" must be disregarded in determining the value of a transferred ownership interest if: (1) the transfer is made to a member of the transferor's family; (2) the transferor's family controls the entity; and (3) there is an "applicable restriction" which either: (a) lapses after the transfer; or (b) may be removed wholly or partially after the transfer by the transferor or any member of his or her family, individually or jointly.

If an applicable restriction is disregarded, the transferred interest which formerly was subject to the restriction is valued as if the restriction does not exist and as if the rights of the transferor are determined under state law.

The Treasury regulations define "applicable restriction" as a restriction which: (a) is a limitation on the ability to liquidate the entity (in whole or in part); and (b) "is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction."[6]

Even if an applicable restriction exists, that restriction will not be affected by I.R.C. § 2704(b) if: (1) it arises as part of any financing or equity participation entered into by the corporation or partnership with a person who is unrelated, as long as the restriction is commercially reasonable; (2) it is imposed or required to be imposed by any federal or state law;

6 Treas. Reg. § 25.2704-2(b).

or (3) it is a restriction that is also subject to I.R.C. § 2703. *See* I.R.C. § 2704(b)(3) and Treas. Reg. § 25.2704-2(b).

1. When There Is a Restriction Against a Limited Partnership Continuing Beyond Either a Certain Point in Time or the Accomplishment of a Particular Undertaking, Is That an "Applicable Restriction" Under I.R.C. § 2704(b)?

If the partnership with a fixed term instead were required to be treated as a partnership at will because its required termination after a period of years is disregarded, then a limited partner would be deemed under state law to have a right to withdraw and be paid "fair value" after six-month's notice. As mentioned throughout this outline, however, the estate tax and gift tax are excise taxes on the *transfer* of property, not direct taxes on what a transferor could have derived from his interest in the partnership. Restrictions which require the consent of all partners before the limited partnership may terminate before the end of its term and prohibiting an assignee or limited partner's withdrawal before the definite time for dissolution are consistent with the restrictions that exist under the Uniform Revised Limited Partnership Act. *See* § 6.03 and 8.01 of the Uniform Revised Limited Partnership Act. Thus, these restrictions are not "applicable restrictions" since they are no more restrictive than state law. Of course, the restriction on the partnership continuing beyond its fixed term is not an "applicable restriction," and cannot be disregarded, because it is only a restriction on *not* liquidating.

2. The Nature of an Assignee's Interest.

Even if I.R.C. § 2704(b) applies to these restrictions with respect to a limited partnership interest, it does not cause the assigned limited partnership interest to be valued at its liquidation value. Under Revenue Ruling 93-12, 1993-1 C.B. 202, fair market value is determined by examining the rights transferred to the assignee, not the rights formerly held by the assignor. In other words, even if the partnership agreement's restrictions on a limited partner's ability to liquidate his limited partnership interest did not exist, any person buying the transferred limited partnership interest would purchase it at a price based on the income value approach or net asset value approach, not its liquidation value, because that person would only be an assignee, not a partner. If the partnership agreement were silent on these matters, a hypothetical buyer still would be concerned with the restrictions on an assignee under state law. The mechanics of I.R.C. § 2704(b) do not require that the valuation be determined as if the transferee's interest has a "put" right. It only requires that the valuation be determined as if the applicable partnership agreement is silent with respect to liquidation restrictions. If the governing investment is silent as to liquidation rights, one then must look to state law to determine the result. Under state law, assignees do not have the right to force a liquidation of the partnership or even the right to petition a court to force a liquidation.

The legislative history of I.R.C. § 2704(b) makes it clear that normal minority interest discounts and other discounts are not to be disregarded. The general discussion portion of the Conference Committee Report dealing with I.R.C. § 2704 states as follows: "These rules do not affect minority discounts or other discounts available under present law." Thus, if the transferee owns only a minority interest in a corporation, or owns only a limited partnership interest as in the above example, and if under state law the minority corporate or limited partnership interest does not have a "put" right or automatic liquidation right, then fractionalization discounts will be applied. In other words, as the legislative history makes clear, if a minority interest in a corporation or a limited partnership interest normally is valued on a income approach or net asset value approach basis, then I.R.C. § 2704(b) will not affect that result. Stated differently, if an entity having a limited term is interpreted as per se containing an "applicable restriction," then the only entities that are not subject to I.R.C. § 2704(b) would be perpetual corporations. No one can argue seriously that such a proposition represents Congressional intent.

3. *Kerr v. Comm'r*.

The Tax Court's opinion in *Kerr v. Comm'r*, 113 T.C. 449 (1999) was the first opinion addressing the IRS's broad interpretation of the provisions of Chapter 14 of the Internal Revenue Code and Congress' intent with respect to those statutes. The Court held that I.R.C. § 2704(b) did not affect the valuation of limited partnership interests transferred by the taxpayers because the restrictions on liquidation in the partnership agreements at issue were not "applicable restrictions" under § 2704(b).

In 1993, the taxpayers and their children formed two family limited partnerships in 1993 (KIL and KFLP). Mr. and Mrs. Kerr simultaneously, with the creation of KFLP, transferred part of their general partnership in KFLP to their four children. Over one year later, the taxpayers created separate grantor retained annuity trusts ("GRATs"), and each transferred 44.535% Class B interests in KFLP to the GRATs. The remainder interests in the GRATs passed to generation skipping trusts pursuant to a formula. The trustees of the GRATs were not formally admitted as limited partners -- no general partner other than the taxpayers consented to the admission of the GRAT trustees as limited partners. The taxpayers also made gifts of interests in KIL to their children. However, under the KIL partnership agreement, the children automatically received partnership interests because they were already partners in the partnership.

In filing their federal gift tax returns for 1994 and 1995, the taxpayers computed the fair market value of the interests transferred by applying valuation adjustments for minority interest and lack of marketability. The IRS, however, determined that § 2704(b) barred any adjustment for minority interest and lack of marketability in computing the fair market value of the partnership interests. The IRS claimed that the provisions of the partnership agreements which restricted the right of a limited partner to liquidate his limited partnership interest were "applicable restrictions" which should be disregarded in determining the fair market value of the interests transferred.

The IRS's argument had two components. First, the IRS claimed that the provisions of the partnership agreements which stated that the partnership shall liquidate upon the earlier of December 31, 2043, or the consent of all the partners, were restrictions on the liquidation of the partnerships that constitute "applicable restrictions" within the meaning of § 2704(b) which must be disregarded in valuing the interests transferred. Second, the IRS claimed that the provisions of the partnership which restricted a limited partner's right to withdraw from the entity were "applicable restrictions" which must be disregarded in valuing the interests transferred. The IRS thus claimed that because a limited partner in a partnership that did not have a fixed term (*i.e.*, December 31, 2043) had the right to withdraw his interest under state law upon six months notice, that the fair market value of the interest is equal to the proportionate pro rata net asset value of the partnership interest transferred.

After the case was put at issue in the Tax Court, the taxpayers filed a motion for partial summary judgment arguing that § 2704(b) did not apply to the valuation of the transferred interests because (1) the taxpayers could only unilaterally transfer assignee interests in KFLP, as opposed to limited partnership interests (the IRS conceded in its brief that if the assigned interest was an assignee interest § 2704(b) did not apply); (2) the restrictions on liquidation and withdrawal in the partnership agreements are not "applicable restrictions" within the meaning of § 2704(b) because a limited partner under Texas law cannot withdraw until the end of a fixed term; (3) the restrictions on withdrawal in the partnership agreements are not "applicable restrictions" because under Texas law a limited partner can only withdraw in accordance with the terms of the partnership agreement; and (4) the family did not have the unilateral right to remove any restriction on liquidation or withdrawal because the University of Texas (who had been given interests in the partnership), as either a limited partner or as an assignee under the terms of each of the partnership agreements, had the right to block that withdrawal or the removal of any such restriction.

As an initial matter, the Court found that the transferred interests transferred to the GRAT trustees were limited partnership interests, and not assignee interests (regardless of the fact that no general partner of KFLP other than the taxpayers consented to the trustees admission as limited partners). Despite this finding, the Court held that § 2704(b) did not apply to the valuation of the transferred interests. The Court's analysis focused on whether the partnership agreements imposed greater restrictions on the liquidation of the partnerships than the limitations that generally would apply under Texas law.

Comparing the liquidation provisions in § 10.01 of the partnership agreements with § 8.01 of the Texas Revised Limited Partnership Act (TRLPA),[7] the Court concluded that § 10.01 did not contain restrictions on liquidation that constitute "applicable restrictions" within the meaning of § 2704(b). The Court reasoned that Texas law provided for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the partnership agreement or upon the written consent of the partners. As such, the restrictions contained in the partnership agreements were no more restrictive than the limitations that generally would apply to the partnerships under Texas law. Stated differently, providing for a fixed term when the partnership must liquidate, according to the Court, is not an "applicable restriction."

Importantly, the Court rejected the IRS's argument that the restrictions in the partnership agreements on withdrawal of a limited partner should be compared with § 6.03 of the

[7] Under § 8.01 of the TRLPA, a partnership shall be dissolved on the earlier of: (1) the currents of events specified in the partnership agreement to cause dissolution; (2) the written consent of all partners to dissolution; (3) the withdrawal of a general partner; or (4) the entry of a decree of judicial dissolution.

TRLPA, which deals with a limited partner's right of withdrawal.[8] The Court found the IRS's reliance on TRLPA § 6.03 was erroneous, stating that TRLPA § 6.03 sets forth limitations on a limited partner's withdrawal from a partnership. The Court noted, however, that "a limited partner may withdraw from a partnership without requiring the dissolution and liquidation of the partnership. In this regard, the Court concluded that TRLPA § 6.03 is not a 'limitation on the ability to liquidate the entity' within the meaning of § 25.2704-2(b)."

The Fifth Circuit affirmed the Tax Court's decision that I.R.C. § 2704(b) does not apply, but on different grounds than the Tax Court. *Kerr v. Comm'r*, 292 F.3d 490 (5th Cir. 2002). Section 2704(b)(2)(B)(i) provides that "the transferor or any member of the transferor's family, either alone or collectively, must have the right to remove the restriction" immediately after the transfer for the restriction to constitute "applicable restriction." Because the University of Texas was a partner in the partnership, the Court held that the Kerr family did not have the right to remove any restriction unilaterally. The Court rejected the IRS's argument that the University of Texas would not oppose the removal of liquidation restrictions if requested by the family because the University wanted to convert its interest to cash as soon as possible. The Court noted that "the Code provides no exception allowing us to disregard non-family partners who have stipulated their probable consent to a removal of the restriction." 292 F.3d at 494. The probable consent of the University "cannot fulfill the requirement that the family be able to remove the restrictions on its own." *Id.* Because the Court affirmed the Tax Court's decision on other grounds, it did not to address the basis for the Tax Court's holding that I.R.C. § 2704(b) did not apply.

4. Drafting Around I.R.C. § 2704(b).

First, a family limited partnership should be designed to terminate after fixed term of years or after a specific undertaking is accomplished. Under the default state law rules, if a partnership is so worded, a limited partner cannot withdraw until the partnership terminates. Second, there should be more than one general partner. If there is only one general partner, however, the general partner's estate should not be given the power to liquidate the partnership or the decedent's interest in the partnership. The use of a charity as a limited partner, as existed in *Kerr*, can also help avoid the application of § 2704(b).

D. The Gift on Formation Argument.

The IRS's argument that a gift occurs when a partnership is created is based on the notion that if the value of the partnership interest received by a partner is less than the value of the assets contributed by the partner (under the fair market value definition of Treas. Reg. § 20.2031-1(b)), a gift has been made because someone must have received a gratuitous transfer of the difference. In support of this argument, the IRS commonly relies on *Comm'r v. Wemyss*, 324 U.S. 303 (1945), in which the Supreme Court stated that "[The gift tax statute by] taxing as

[8] Under § 6.03 of the TRLPA which was in existence in 1994 and 1995, a limited partner could "withdraw from a limited partnership at the time or on the occurrence of events specified in a written partnership agreement and in accordance with that written partnership agreement. ***If the partnership agreement does not specify such a time*** or event or define a time for the dissolution and winding up of the limited partnership, a limited partner may withdraw on giving written notice not less than six months before the date of withdrawal to each general partner." (emphasis added).

gifts transfers that are not made for 'adequate and full [money] consideration' aims to reach those transfers which are withdrawn from the donor's estate." 324 U.S. at 307-308.

A donative transfer, by definition, requires the presence of a donor, a donee, and a transfer having the quality of a gift. *Comm'r v. Hogle*, 165 F.2d 352, 353 (10th Cir. 1947) ("[T]he [gift] tax cannot be sustained unless there was a transferor, a transferee, and an effective transfer of title or other economic interest or benefit in property having the quality of a gift."). If any one of those three elements is missing, a taxable transfer has not occurred. As the Supreme Court stated in *Dickman v. Comm'r*, 465 U.S. 330, 334 (1984):

> The words "transfer . . . by gift" and whether . . . "direct or indirect" are designed to cover and comprehend all transactions . . . whereby, and to the extent . . . that, property or a property right ***is donatively passed to or conferred upon another***, regardless of the means or device employed in its accomplishment.

465 U.S. at 334 (emphasis added), *quoting* H.R. Rep. No. 708, 72d Cong., 1st Sess., 27-28 (1932); S. Rep. No. 665, 72d Cong., 1st Sess., 39 (1932).

The IRS's claim that a transfer occurred when a pro-rata partnership was created ignores the fact that partnership interests in a pro-rata partnership are divided on a pro rata basis between the partners based upon their contribution of assets. The creation of the partnership does not confer a financial benefit on or increase the wealth of any partner. A gift does not occur, and never can in the formation of a business entity in which each investor's interest is proportional to the capital contributed. *See Church v. United States*, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369; 85 A.F.T.R.2d (RIA) 804 (W.D. Tex. January 18, 2000).

The Court of Claims' decision in *Chanin v. United States*, 393 F.2d 972 (Ct. Cl. 1968), is instructive on this point. In *Chanin*, shareholders of a corporation made transfers to the corporation on a pro-rata basis. The IRS claimed that a gift occurred because the increase in the value of each donor's shares was less than the value of the assets transferred by the donor. The Court rejected the IRS's position, holding as follows:

> Certainly when the gifts to the donee stockholders are to be evaluated on this basis, it is fair and reasonable to determine the retained interest in the same manner. At the least that is true, as here, in the absence of any real fair market value, adequately ascertained. The whole is thus made equal to the sum of its parts. Otherwise, different standards would be applied on the "transferred" and "received" sides of the equation. The donors were in a sense also donees, except that it is illogical to say that a person can give property to himself. But in lieu of being a donee, the donor has "received" in the same sense that he had retained his proportionate share of the overall gifts.

Id. at 980 (emphasis added). *See also Heringer v. Comm'r*, 235 F.2d 149 (9th Cir. 1956).

1. A Gift Does Not Occur Where the Creation of the Partnership Was a Bona Fide Arm's-Length Transaction That Was Free from Donative Intent.

The "ordinary course of business" provision under Treas. Reg. § 25.2512-8 deems a transaction to be for "adequate and full consideration" under I.R.C. § 2512(b), even if the purported transferor receives less consideration than a hypothetical willing seller would receive. A transfer is deemed to be for adequate and full consideration, and not subject to tax, if made "in the ordinary course of business (a transaction which is bona fide, at arm's-length, and free from donative intent)." Treas. Reg. § 25.2512-8.

The creation of a mechanism to ensure family ownership and control of a family enterprise has long been held by the Tax Court to constitute a bona fide and valid business purpose. *See Estate of Bischoff v. Comm'r*, 69 T.C. 32, 39-41 (1977); *Estate of Reynolds v. Comm'r*, 55 T.C. 172, 194 (1970), *acq.*, 1971-2 C.B. 1; *Estate of Littick v. Comm'r*, 31 T.C. 181, 187 (1958), *acq. in result*, 1984-2 C.B. 1; *Estate of Harrison*, 52 T.C.M. (CCH) at 1309 (holding that "[w]ith respect to business purpose, petitioner presented convincing proof that the partnership was created as a means of providing necessary and proper management of decedent's properties and that the partnership was advantageous to and in the best interests of decedent"). Finally, the creation of a pro rata partnership for a valid business purpose where the interests of each partner are based upon the value of the assets contributed to the entity has been held as arm's-length and free from donative intent. *See, e.g.*, *Church v. United States*, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369; 85 A.F.T.R.2d (RIA) 804 (W.D. Tex. January 18, 2000).

2. A Partner Cannot Make a Gift to Herself.

The IRS's claim that a gift on formation of the Partnership occurred also suffers from another fatal flaw -- a partner cannot not make a gift to herself. Assume that at formation, Mrs. Jones owned a 90% partnership interest in the partnership, and other family members own the rest. The partnership is pro rata and each family member received an interest in the partnership equal to the value of the assets contributed. The IRS would argue that because the value of Mrs. Jones' interest in the partnership was worth less than the assets she contributed, she has made a gift equal to the difference between the value of the assets received and the value of the assets transferred. If a gift was made by Mrs. Jones, she was the recipient of 90% of that gift. *See Kincaid v. United States*, 682 F.2d 1220, 1225 (5th Cir. 1982) (noting that the taxpayer could not make a gift to herself when she transferred her ranch to a newly formed corporation that she and her two sons owned all of the voting stock, the Court held that she had made a gift to each of her sons of one-third of the total gift amount); *Estate of Hitchon v. Comm'r*, 45 T.C. 96 (1965) (father's transfer of stock to a family corporation for no consideration constituted gift by father of one-quarter interest to each of three shareholder sons).

a. *Shepherd v. Comm'r*.

On the other hand, in a case where a father and his two sons created a partnership and the father, at creation, transferred all of the assets to the partnership, and the sons made no individual capital contribution, the Tax Court held that the father had made gifts of undivided interests in the real estate and securities transferred to the partnership to the extent those properties were attributed to his sons' capital accounts. *Shepherd v. Comm'r*, 115 T.C. 376

(2000). The Court reasoned that because a partnership of one cannot exist, the father made indirect gifts of the property transferred to the partnership, and not of the partnership interests that the sons received. In language which should give some level of comfort to creators of pro rata partnerships, the Tax Court stated that "obviously, not every capital contribution to a partnership results in a gift to the other partners, particularly where the contributing partner's capital account is increased by the amount of the contribution, thus entitling him to recoup the same amount upon liquidation of the partnership." *Id.* at 389. The Court also held, however, that the transfer should be treated as separate transfers of 25% to each son, and applied undivided interest discounts in determining the value of the gifts.

b. *Estate of Strangi v. Comm'r.*

In *Estate of Strangi*, 115 T.C. 478 (2000), decedent formed a family limited partnership with his children and transferred assets to the partnership in return for a 99% limited partnership interest. The IRS argued that the decedent had made a gift when he transferred property to the partnership and received in return a limited partnership interest of lesser value. The Tax Court held that, because the taxpayer received a continuing interest in the family limited partnership and his contribution was allocated to his own capital account, the taxpayer had not made a gift at the time of the contribution. Although the *Strangi* court rejected the IRS's gift on formation argument, it appeared to do so because the Tax Court did not believe that the decedent gave up control of his assets. As the Court stated, "in view of decedent's continuing interest in SFLP and the reflection of the contributions in his own capital account, he did not transfer more than a miniscule proportion of the value that would be 'lost' on the conveyance of his assets for the partnership in exchange for a partnership interest." *Strangi*, 115 T.C. at 490.

c. *Estate of Jones v. Comm'r.*

The Tax Court dealt the IRS's gift on formation a significant blow in *Estate of Jones v. Comm'r,* 116 T.C. 121 (2001). In that case, Mr. Jones formed a family limited partnership with his son and transferred assets including real property in exchange for a 95.5389% limited partnership interest. He also formed a family limited partnership with his four daughters and transferred real property to it in exchange for an 88.178% limited partnership interest. The son contributed real property in exchange for general and limited partnership interests in the first partnership, and the daughters contributed real property in exchange for general and limited partnership interests in the second partnership. All of the contributions were properly reflected in the capital accounts of the contributing partners. The IRS argued that Mr. Jones made taxable gifts upon contributing his property to the partnerships. "Using the value reported by decedent on his gift tax return, the IRS argues that, if decedent gave up property worth $17,615,857 and received back limited partnership interests worth only $6,675,156, decedent made taxable gifts upon the formation of the partnerships equal to the difference in value." *Id*. at 127.

The Tax Court held that the contributions of property were similar to the contributions in *Estate of Strangi* and distinguishable from the gifts in Shepherd. "Decedent contributed property to the partnerships and received continuing limited partnership interests in return. Although the contributions of property were properly reflected in the capital accounts of decedent, and the value of the other partners' interests was not enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts." *Id.* at 128. Thus, even though Mr. Jones contributed most of the assets to the partnerships and received noncontrolling limited partnership interests in return, the Court held that he did not make a taxable gift on the formation of the partnerships because his contributions were properly reflected in his capital accounts when the entity was created and the value of the other partners' interests was not enhanced by his contributions.

d. *Senda v. Comm'r.*

In *Senda*, T.C. Memo 2004-160 (July 12, 2004), husband and wife ("H and W") signed a partnership agreement on April 1, 1998, and the certificate of limited partnership was issued on June 3, 1998. On December 28, 1998, H and W contributed approximately $1.8 million worth of MCI WorldCom stock to a partnership, and their children purportedly transferred oral accounts receivable for their partnership interests (which were .10% limited partnership interests). The accounts receivable were never reduced to writing, had no terms for repayment, and had not been paid as of the time of trial. On that same day, H and W sent a facsimile to their accountant to inform him of the transfer of stock and (except for charges) to ask what percentage of the limited partnership interest they should transfer to their children. Later that day, H gave each child a 29.94657% LP interest, and W gave each child a .0434% LP interest. The court noted that "the certificates of ownership reflecting these transfers were not prepared and signed until several years thereafter."

A second partnership was created in 1999 in a similar manner. However, the facsimile to the accountant regarding what percentage interest in the second partnership should be given to the children was sent two days after the purported gifts of the partnership interests.

The IRS argued, and the Tax Court agreed, that the transfers of stock to the partnerships and the gifts of limited partnership interests to the children should be as gifts of the underlying stock (without discounts) rather than as gifts of discounted limited partnership interest. Relying on *Shepherd v. Comm'r*, the Court concluded that there were no records or other reliable evidence that the parents contributed the stock to the partnerships before they made the gifts of partnership interests to the children. Although the parents argued that their capital accounts were increased by the amount of their contributions of stock to the partnership before the gifts were made, the Court found no evidence that the contributions were ever reflected in the parents' capital accounts.

The Eighth Circuit affirmed the Tax Court's decision, holding that the transfers of stock to the partnerships were indirect gifts of stock to the children because the taxpayers did not present reliable evidence that they contributed the stock to the partnerships before they transferred the interests to the children. The Court held that the Tax Court did not clearly err when it reached its conclusion as the evidence demonstrated that (1) the husband, as general partner, did not maintain any books and records for the partnerships, and (2) there was considerable delay in preparing the tax returns and the certificates of ownership after the transfers. The Court further noted that letters from the tax advisors were inconclusive in proving that the taxpayers transferred the stock before transferring the partnership interests. *See Senda v. Comm'r*, 433 F.3d 1044 (8th Cir. 2006).

E. I.R.C. § 2036(a).

The primary area in which the IRS has experienced success in connection with its challenges to family limited partnerships involved situations where the taxpayers failed to respect the integrity of the entity. In these cases, the Tax Court has used I.R.C. § 2036(a) to bring a value of the assets of the partnership back into the decedent's estate as a retained life interest. Section 2036(a) provides as follows:

> (a) GENERAL RULE—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

1. *Estate of Reichardt v. Comm'r.*

In *Reichardt,* 114 T.C. 144 (2000), Judge Colvin agreed with the IRS that the substance of the partnership transaction was that Mr. Reichardt and his children had an implied agreement to allow Mr. Reichardt to continue to substantively enjoy the property contributed to the partnership and retain the right to income from the partnership assets during his lifetime in the same manner he had before the creation of the partnership. The Court found that the transfers to the partnership did not affect Mr. Reichardt's enjoyment of the property. Mr. Reichardt also continued to manage the property in the same fashion that he had before. The Court also found that Mr. Reichardt commingled partnership and personal funds, enjoyed the use of the personal residence, which was contributed to the partnership, without paying rent, and that Mr. Reichardt was solely responsible for the partnership's business activities.

2. *Estate of Schauerhamer v. Comm'r.*

In *Schauerhamer,* 73 T.C.M. (CCH) 2855 (1997), Judge Foley held that the value of assets transferred by decedent to three family limited partnerships were included in the decedent's estate under I.R.C. § 2036 because she deposited the income produced by the partnership assets in her personal checking account and did not maintain separate records for partnership and non-partnership funds.

3. *Church v. Comm'r.*

On January 18, 2000, the United States District Court for the Western District of Texas released its Findings of Fact and Conclusions of Law in this case. *Church v. United States*, 85 A.F.T.R.2d (RIA) 804 (W.D. Tex. 2000), aff'd without published opinion, 268 F.3d 1063 (5th Cir. 2001) (per curiam), unpublished opinion available at 88 A.F.T.R.2d 2001-5352 (5th Cir. 2001). Mrs. Church died on October 24, 1993. Two days prior to her death, Mrs. Church and two other persons signed an agreement entitled "Agreement of Sturnberg Ranch Partners, Ltd." Testimony established that the purpose of the partnership was twofold: (1) the partners wished to consolidate their undivided interests in a 23,000 acre family ranch to provide for centralized management of their interests and preserve the ranch as an ongoing enterprise for future generations; and (2) Mrs. Church had become concerned about protecting her substantial assets from judgment creditors in the event of a catastrophic tort claim against her. In addition to her contribution of her undivided interest in the ranch, Mrs. Church also contributed approximately $1 million in securities to the partnership. The Certificate of Limited Partnership was not filed in the Office of the Texas Secretary of State until October 26, 1993, two days after Mrs. Church's death. The corporate general partner of the partnership was not actually organized until March of 1994, several months after Mrs. Church's death.

At the time that the partnership was formed, Mrs. Church had been previously diagnosed with breast cancer. However, the Court factually concluded that Mrs. Church died "suddenly and unexpectedly of cardiopulmonary collapse" and that the cause and timing of Mrs. Church's death "is largely irrelevant to this case" and "unrelated to her cancer." (emphasis added). The District Court specifically observed that the primary purpose of the partners in forming the partnership was a desire to preserve the family ranching enterprise for themselves and their descendants and "evidence of this motivation is concrete and persuasive." The District Court also specifically found the following:

> (i) that the partnership had bona fide business purposes . . .
>
> (ii) The partnership was not formed solely to reduce estate taxes.
>
> (iii) There was no express or implied agreement between the partners in the partnership that Mrs. Church could continue to use, possess, or enjoy partnership property or retain the right to income from the partnership property . . .
>
> (iv) The partnership was a bona fide business arrangement and not a devise to transfer property to Mrs. Church's family for less than full and adequate consideration . . .
>
> (v) The terms and restrictions in the partnership agreement were comparable to similar arrangements entered into by persons in arm's-length transactions.

The District Court also made specific findings as to valuation matters. The Court determined that assets contributed by Mrs. Church to the partnership were valued at $1,467,748 and that the fair market value of her limited partnership interest in the partnership was $617,591, a discount in excess of 50%. The District Court noted that the "government chose not to present any valuation evidence of its own."

> The District Court made the following Conclusions of Law:
>
> (i) That the formation of the partnership was "in substantial compliance in good faith with the Texas Revised Limited Partnership Act."
>
> (ii) That the partnership was a "valid Texas limited partnership as of October 22, 1993."
>
> (iii) Under well established principles of Texas law, ownership of property intended to be partnership property is not determined by legal title, but rather by the intention of the parties.
>
> (iv) That no taxable gift had been made in this case since "a taxable gift must involve a gratuitous transfer, which by definition requires a donee" and there was no donee in this case.

The District Court also rejected the government's allegations under I.R.C. §§ 2036 and 2038, finding that there had been no gratuitous transfer and further rejected the government's assertions that I.R.C. § 2703 could be interpreted to disregard the existence of the partnership. The Justice Department appealed *Church* the issues regarding partnership formation to the United States Court of Appeals for the Fifth Circuit. It did not appeal the tax issues. The Fifth Circuit's per curium opinion, which was filed on July 18, 2001, was very brief:

> The judgment of the district court is affirmed for the following reasons:
>
> The only issue of the estate's valuation is whether the transfer of the assets was restricted at the time of Church's death. Different legal theories have been argued during the course of this proceeding, but that has always been the dispositive question - as it was the basis for the different valuations given the assets by the appraiser (not now questioned). Regardless of the status of the limited partnership due to the certificate not being filed on that date, the documents that Church had signed imposed restrictions on the assets that necessarily caused their value to be discounted even if no limited partnership was then formed.
>
> We reject the government's argument that the 1999 revision of the Texas statute made the filing of the certificate an absolute prerequisite to the creation of a limited partnership and rendered an agreement between the parties unenforceable until the time of filing. A Texas court has held that a written partnership agreement constitutes an enforceable contract and governs the rights of the

parties. *Hoagland v. Finholt*, 773 S.W.2d 740, 742-43 (Tex. App.—Dallas, 1989, no writ). Further, the Bar Committee's commentary to the 1999 revision of section 2.01 states that the revision was not meant to overturn *Garrett v. Koepke*, 569 S.W.2d 568 (Tex. Civ. App.—Dallas, 1978, writ ref'd n.r.e.), which held that an entity could operate as a limited partnership before filing a certificate. Tex. Rev. Civ. Stat. Ann. art. 6132a-1 2.01, Source and Comment - Bar Committee (Vernon Supp. 2001).

The estate stated in its pleadings that the discounts for lack of control applied without the formation of a limited partnership, and in its refund claim it stated that it was entitled to a "discount for lack of control and marketability." The IRS was apprised of the nature of the refund action.

AFFIRMED

4. *Estate of Harper v. Comm'r.*

In *Harper*, 83 T.C.M. (CCH) 1641 (2002), the Tax Court held that property contributed by an individual to a family limited partnership was includable in his gross estate under I.R.C. § 2036(a) because he retained the enjoyment of the property during his lifetime.

Harper set up a living trust with a portfolio of assets which constituted the vast majority of his net worth. During 1994, Harper formed a family limited partnership. His children received a 1% general partnership interest, and the trust received a 99% limited partnership interest. On July 1, 1994, the trust assigned a 24% interest to one child and a 36% interest to another child and reported the transaction as a gift. Harper died on February 1, 1995.

The IRS argued that the full fair market value of the assets contributed to the partnership by the trust should be included in his estate under I.R.C. § 2036(a) because the facts of the case demonstrated that although the assets were contributed to the partnership, Mr. Harper retained the economic benefit of the assets and the right to use those assets during his lifetime. The taxpayer argued that § 2036(a) should not apply because the trust transferred the assets to the partnership and what was owned by Mr. Harper at the time of his death were interests in the partnership, that the trust received full and adequate consideration for the transfer under I.R.C. § 2036(a), and there was no agreement that Mr. Harper would retain the right to the control of, or the income generated by, the property.

The Tax Court concluded that I.R.C. § 2036(a) applied to bring all of the assets contributed by the trust into Mr. Harper's taxable estate. The Tax Court's analysis was centered on the taxpayer's failure to respect the partnership as a separate entity. Specifically, the Court noted that the partnership had a history of disproportionate distributions, funds of the partnership were commingled with Mr. Harper's personal funds, and that a significant delay existed between the date the partnership was formed and the date that the assets of the partnership were transferred to it. In sum, the Court found "compelling indicia of an implied understanding or agreement that the partnership would not curtail the decedent's ability to enjoy the economic benefit of asserts contributed to the" partnership.

The Tax Court also rejected the estate's argument that § 2036(a) did not apply because the trust received full and adequate consideration for the transfer. The Court held that 2036(a) does not apply "in the case of a bona fide sale for an adequate and full consideration in money or money's worth." The Court held that because the children did not transfer any assets to the partnership upon formation, the decedent alone determined how the partnership would be structured and operated, so there was no arm's length agreement. The Court referred to this as a "pure recycling" of interests. The Court thus noted that the transfer was not an arm's length transaction but rather a transaction within the context of § 2036 which was "testamentary" in nature.

5. *Estate of Thompson v. Comm'r.*

In *Thompson*, 84 T.C.M. (CCH) 374 (2002), Mr. Thompson formed a family limited partnership with his daughter and son-in-law and a second partnership with his son two years before his death. The partners also created two corporations to serve as the general partners for each of the partnerships. Mr. Thompson contributed over $1.4 million in securities and notes receivable to each of the partnerships, receiving a 95.4% and 62.27% limited partnership interest in each partnership in return. During the two years before Mr. Thompson's death, the partnerships collectively distributed nearly $100,000 to Mr. Thompson, which he used to make gifts to family members and pay personal expenses. At trial one of the children testified that she wanted to make sure that despite the creation of the partnership, Mr. Thompson could in fact obtain funds from the partnership to make gifts to his children.

The IRS argued that under I.R.C. § 2036, the total value of the decedent's interest in the partnership was equal to its pro rata net asset value. The Tax Court held that while the partnerships had sufficient substance to be recognized for estate and gift tax purposes (observing that the partnerships were validly created under state law), it found an implied agreement that the decedent would retain the economic benefit of the contributed property, thereby requiring an inclusion of those assets in his gross estate under I.R.C. § 2036(a)(1). The Court noted that because the decedent transferred assets to the partnerships that would have been required for his support, there had been an implied understanding this his children would agree to his request for money from the property that he contributed and that the partnerships were created primarily as an alternative vehicle for implementing the decedent's estate plan. The Court further noted that the decedent's transfer of assets to the partnerships was not a bona fide sale for adequate and full consideration because the decedent's receipt of partnership interests was merely a "recycling of value" and the contribution was not motivated by legitimate business concerns.

The Third Circuit Court of Appeals affirmed the Tax Court's decision in *Betsy T. Turner, Executrix of the Estate of Theodore Thompson, Deceased v. Commissioner of Internal Revenue*, No. 03-3173 (3rd Cir. September 1, 2004). In reviewing the Tax Court's decision to apply § 2036 to the assets contributed by the decedent to the partnerships, the Third Circuit examined the Tax Court's opinion to determine whether the Tax Court had committed "clear error" in reaching its decision.

First, the Third Circuit affirmed the Tax Court's factual finding that because of the way the partnerships' affairs had been managed, it was clear that an implied agreement existed between the decedent and his children that the decedent retained the right to the property and the income from the property that he transferred to the partnerships.

Second, the Third Circuit specifically found that there was no non-tax reason for the creation of the partnerships other than transfer tax savings, and affirmed the Tax Court's finding that the transfer of assets to the partnerships did not satisfy the "bona fide sale for adequate and full consideration" exemption to § 2036. The Third Circuit noted that

> [T]he Tax Court had concluded that there were no transfers for consideration because the transactions "were not motivated by . . . legitimate business concerns. It found none of the individual partners conducted an active business in the partnerships or pooled their assets with the assets contributed by the decedent. Each contributing partner directly received any income derived from the assets he or she contributed to the partnerships. The partnerships held the securities transferred by the decedent without any substantial change in investment strategy, and did not engage in business transactions with anyone outside of the family. As such, the Tax Court found the family limited partnerships served as "a vehicle for changing the form in which the decedent held his property – a mere 'recycling of value,'" and therefore concluded there was no transfer for consideration with the meaning of § 2036(a).

Op. at 13.

The Third Circuit noted that "the operations of the Turner partnerships . . . failed to provide sufficient objective indicia of a legitimate business operation." Op. at 15. The Court focused on the fact that loan transactions entered into by family members were intra-family only, and interest payments were either late or never paid, and the partnerships took no enforce of an action against the delinquent debtors. The Court also noted that the partners had amended the partnership agreements retroactively to allocate all gains and losses from, and the distribution of real estate contributed to the partnerships, to the individual contributing partner.

The most disturbing language in the opinion focuses on the fact that the principal assets in the partnerships were non-traded marketable securities. The Court stated:

> In addition to the lack of legitimate business operations, the form of the transferred assets – predominately marketable securities – is significant to our assessment of the potential non-tax benefits available to decedent as a result of the transfer. Other than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio securities in this family limited partnership with no ongoing business operations.

Op. at 16. In reaching this conclusion, the Court relied on several cases cited in this outline (*Church*, *Stone*, and *Kimbell*) for the proposition that some benefit other than estate tax savings must be present for the investment to be considered bona fide. These cases (all of which had entities owning a substantial amount of marketable securities) stand for the proposition that family management and control of assets is an important non-tax reason supporting the bona fides of the entity at issue.

The Third Circuit also noted that evidence of "an arm's length transaction" or "bargain for exchange" is highly probative to the § 2036 inquiry. Op. at 19. The Third Circuit noted that even in the absence of an arm's length transaction, a transaction must still be made in good faith and that "a good faith transfer to a family limited partnership must provide the transfer or some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form." The Court noted that:

> Objective indicia that the partnership operates a legitimate business may provide a sufficient factual basis for finding a good faith transfer. But if there is no discernable purpose or benefit for the transfer other than estate tax savings, the sale is not 'bona fide' within the meaning of § 2036.

Op. at 19.

6. *Estate of Strangi v. Comm'r.*

In 1993, Mr. Strangi experienced health problems, and his son-in-law, an attorney with an estate planning background, took over his affairs under a power of attorney. In 1994, the decedent's son-in-law formed a family limited partnership with an LLC as its corporate general partner. A certificate of limited partnership was filed with the Texas Secretary of State and Mr. Strangi's assets were transferred under the power of attorney to the partnership in exchange for a 99% limited partnership interest. All of the contributed property was reflected in Strangi's capital account and had a fair market value of $9,876,929. Mr. Strangi's four children (who were the residuary beneficiaries of his estate) acquired an interest in the corporate general partner. Mr. Strangi owned 47% of the corporate general partner, and his children collectively owned the remaining 53%. The son-in-law managed the day-to-day affairs of the entities. Mr. Strangi died two months after the creation of the partnership. The estate valued the decedent's interest in the entities at $6.5 million, applying combined discounts for lack of control and lack of marketability of 43%.

The Estate claimed that the partnership was formed to (1) reduce executor and attorney's fees payable at the death of decedent; (2) insulate decedent from an anticipated tort claim and the estate from a will contest; and (3) to provide a joint investment vehicle for management of decedent's estate. In the majority opinion,[9] the Tax Court noted its skepticism, based upon the facts of the case, of the Estate's claims of business purposes relating to the creation of the partnership and noted that no active business was conducted by the partnership following its formation. However, the Court specifically found that the partnership was validly formed under Texas law and as a legal matter, changed the relationships between decedent and his heirs and decedent and actual and potential creditors. The Court explicitly found that all partnership formalities were followed, and the proverbial "i's were dotted" and "t's were crossed." *Strangi v. Comm'r,* 115 T.C. 478 (2000) ("*Strangi I*"). Ignoring the subjective intentions of the parties in creating the partnership (*i.e*. the Tax Court's implied conclusion that the partnership was formed primarily to reduce estate taxes), the Court held that "the partnership had sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent's assets, and we do not disregard it in this case." 115 T.C. 478 at 486-87. The majority also disregarded the IRS's claim that I.R.C. § 2703(a)(2) could be used to completely disregard the existence of the entity.

The Tax Court also rejected the IRS's claim that the decedent made a gift when he transferred property to the partnership and received in return a limited partnership interest of lesser value. The Court noted that using the value reported on the estate tax return, if the decedent gave up property worth in excess of $10 million and received a limited partnership interest worth approximately $6.5 million in return, he appears to have made a gift equal to the loss in value. But the Court held that no taxable gift occurred when the partnership was formed, stating that "[i]n view of decedent's continuing interest in [the partnership] and the reflection of the contributions in his own capital account, he did not transfer more than a minuscule proportion of the value that would be 'loss' on the conveyance of his assets to the partnership in exchange for a partnership interest." 115 T.C. 478 at 490.

In fact, the Tax Court signaled to the IRS that it would be receptive to an argument that the partnership property should be included in Mr. Strangi's estate under I.R.C. § 2036 because of the level of control retained by Mr. Strangi's son-in-law as attorney-in-fact (who held a 99% limited partnership interest and 47% stock ownership in the corporate general partner). However, given the Court's holding that no donative transfer occurred upon creation of the partnership, it is hard for this writer to see how I.R.C. § 2036 could apply with respect to the creation of the partnership, since I.R.C. § 2036(a) requires "property . . . of which the decedent has at any time made a transfer (except in the case of a bona fide sale for adequate and full consideration in money or money's worth)."

The taxpayer's valuation expert applied a total discount of 43.75% in valuing the decedent's partnership interest, but disregarded the relationship between the decedent's 99% limited partnership interest and his 47% interest in the stock of the corporate general

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[9] Seven of the fifteen Tax Court judges agreed with the majority opinion (Judges Cohen, Chabot, Whalen, Colvin, Halpern, Chiechi and Thornton). The concurrences and dissents in *Strangi* include the repudiation of the economic substance test of entities in the transfer tax context (Judges Foley and Wells), a request for a more stringent application of the economic substance doctrine (Judges Parr, Beghe, and Marvel), an argument that the presence of an estate tax valuation discount virtually compels a finding of a gift on creation (Judges Reue, Parr, Beghe, Gale, and Marvel), and an estate depletion theory (Judges Beghe, and Parr). Although Judge Laro concurred in the majority opinion, he did not sign on to any of the concurring opinions.

partner. The Tax Court was of the view that Mr. Strangi's interests must be examined together in determining fair market value, and rejected the taxpayer's valuation.

The IRS's appraiser applied total discounts of 31% in valuing Mr. Strangi's partnership interest (consisting of an 8% lack of control discount and a 25% lack of marketability discount). The Court accepted the IRS's appraiser's determination of value, stating that it felt "constrained to accept the evidence concerning discounts applicable to decedent's interest in the partnership and in Stanco as of the date of death." 115 T.C. at 492. The Court also stated that "we believe that the result of the IRS's expert's discounts may be still be overgenerous to petitioner, but that result is one that we must reach under the evidence and under the applicable statutes." *Id.*

On June 17, 2002, the Fifth Circuit Court of Appeals affirmed in part, and reversed in part, the Tax Court's decision. *Estate of Strangi v. Comm'r*, 293 F.3d 279 (5th Cir. 2002). The Court affirmed the Tax Court's findings that the partnership had a valid business purpose and economic substance, as well as the Tax Court's holdings under I.R.C. § 2703 and gift on formation. The Court reversed the Tax Court's denial of the IRS's motion to amend to add a claim alleging that under I.R.C. § 2036, the gross estate should include the value of the partnership's assets. The Tax Court denied the motion to amend, which was made 52 days before trial, because it considered the motion untimely. However, the Court held that because the denial of the motion to amend was not based upon on any stated reason (such as prejudice or delay), the Tax Court abused its discretion in denying leave to amend. The Court remanded the case to the Tax Court for consideration of the I.R.C. § 2036 issue.

On remand, the Tax Court addressed the application of I.R.C. §§ 2036(a)(1) and (a)(2) to the partnership in a memorandum decision. *Estate of Strangi v. Comm'r*, 85 T.C.M. 1331 (2003)("*Strangi II*"). The Court found that both applied. Relying on the Court's prior decisions in *Harper*, *Thompson*, and other cases, Judge Cohen found that § 2036(a)(1) applied because Mr. Strangi had impliedly retained the right to the assets from any income from the assets transferred to the partnership. The "bad facts" relied upon by the Tax Court included the fact that Mr. Strangi transferred a majority of his assets to the partnership, leaving him with little assets to pay for his personal needs, his rent-free occupancy of the home following its transfer to the partnership, and the payment of partnership funds to cover his personal expenses, including medical expenses and taxes.

The Tax Court also addressed the application of I.R.C. § 2036(a)(2). This provision requires inclusion of transferred property in which a decedent retained "the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the property or the income therefrom." The taxpayer argued that I.R.C. § 2036(a)(2) did not apply, primarily relying on *United States v. Byrum*, 408 U.S. 125 (1972) for the proposition that Mr. Strangi retained no legally enforceable rights and that his management powers were limited by fiduciary obligation which did not cause estate inclusion. The Court found that *Byrum* did not provide any basis for "presuming the fiduciary obligations would be enforced in circumstances divorced from the safeguards of business operations in meaningful independent interests or oversights." There were three primary reasons for the Court's opinion. First, there was no third party control. Mr. Strangi, in the Court's view, retained control either through his son-in-law's attorney-in-fact or alone. Second, Mr. Strangi was not constrained by any business reality (that had been the case in *Byrum*) that would dictate decision-making. Third, Strangi was not constrained in the exercise of control by any unrelated independent parties who would be expected to enforce Strangi's fiduciary duties.

On July 15, the Fifth Circuit Court of Appeals upheld the Tax Court's decision in *Estate of Strangi v. Comm'r*. In *Strangi*, the Tax Court had held that the full value of the assets transferred to a family limited partnership within three months of Mr. Strangi's death should be included in his estate under §§ 2036(a)(1) and (2).

A threshold question for the Court of Appeals was whether the Tax Court committed "clear error" in determining that Mr. Strangi had retained the right to "possess or enjoy" the property transferred to the partnership under § 2036(a)(1). The Fifth Circuit concluded that the Tax Court did not commit clear error in determining that there was an implicit agreement with Mr. Strangi's children that allowed Mr. Strangi to retain enjoyment of his property after the creation of the partnership. Findings focused on by the Fifth Circuit included (1) the fact that Mr. Strangi lived in the house he transferred to the partnership without the payment of rent during his life, (2) the small amount of assets retained by Mr. Strangi outside of the partnership, and (3) the use of partnership distributions to pay a number of personal expenses and post-death expenses.

The Fifth Circuit also addressed the "bona fide sale for full and adequate consideration" exception to § 2036. The Fifth Circuit opined that a sale is bona fide if "as an objective matter, it serves a substantial business [or] other non-tax purpose." The Estate submitted five non-tax reasons for the transfer of assets to the partnership. The reasons included (1) deterring potential tort litigation by Mr. Strangi's former housekeeper; (2) deterring a potential will contest; (3) persuading a corporate executor to decline to serve; (4) creating a joint investment vehicle for the partners; and (5) permitting centralized, active management of working interest owned by Mr. Strangi. At trial, the Tax Court rejected each of these rationales as implausible based upon the facts of the case. Once again, the Fifth Circuit reviewed the Tax Court's findings for "clear error." The appeals court noted that "we ask only whether the Tax Court's findings are supported by evidence in the record as a whole, not whether we would necessarily reach the same conclusion." Based upon the evidence presented at trial and summarized in the Tax Court's opinion, the Fifth Circuit held that the Tax Court did not commit clear error in reaching the factual conclusion that the transfer of assets to the partnership did not result in a bona fide sale.

Because the Estate had the burden to show that the Tax Court committed "clear error" in reaching its factual findings regarding an implied agreement and bona fide sale, the Estate had an uphill battle in reversing the Tax Court's decision. In other words, the court of appeals was not free to reach its own factual determinations from the evidence presented – the court could only reverse if it concluded the Tax Court committed clear error in reaching its decision. As such, the application of *Strangi* to other cases will be limited. Unfortunately, what is missing from the Court's opinion is a review of the Tax Court's § 2036(a)(2) analysis, which many planners were eagerly anticipating. But the Fifth Circuit's failure to address the § 2036(a)(2) analysis should not be considered tacit approval of the Tax Court's opinion on that issue. Since the Fifth Circuit determined that the assets should be included in Mr. Strangi's estate under § 2036(a)(1), judicial economy dictated that there was no need for the Court to address the § 2036(2) analysis.

7. *Estate of Cohen v. Comm'r.*

The § 2036(a)(2) position taken by the Tax Court in *Strangi* is contrary to the position taken by the Tax Court in *Estate of Cohen v. Comm'r*, 79 T.C. 1015 (1982). In *Cohen*, the decedent was a co-trustee of a Massachusetts business trust. The trust agreement gave the decedent and his co-trustees broad management powers with respect to the property of the trust, including the discretionary power to determine whether to declare dividends on common shares of the business trust. The IRS argued that the dividend power possessed by the decedent and his co-trustees gave them the "right" to designate the persons who enjoy trust income. *Id.* at 1023.

The Court began its discussion by analyzing *Byrum*, noting that the *Byrum* court

> [R]ejected the contention that this de facto power to affect dividend policy was "tantamount to the right to designate the persons who shall enjoy trust income" (408 U.S. at 144), emphasizing the fiduciary obligations imposed upon both majority shareholders and corporate directors under the applicable local law. In view of these fiduciary constraints, Byrum's theoretical power in respect of dividends was not an "ascertainable and legally enforceable" right (408 U.S. at 136-37), and thus was not a "right" within the meaning of section 2036(a)(2).

Id. at 1023-24.

The *Cohen* Court emphasized the similarities between the Massachusetts business trust and the corporation in *Byrum*, and stated that "the very fact that we are concerned here with the declaration of ***dividends*** on ***shares*** representing interests in the entity bolsters the corporate analogy, and thus the relevance of *Byrum*." *Id.* at 1025. The Court further opined that

> In *Byrum*, the critical impediments to the transformation of the power to affect dividend policy into a right to designate enjoyment where the fiduciary obligations imposed by local law on *Byrum* as a controlling shareholder and on the corporate directors he could elect. Therefore, the issue here must turn upon the construction of this trust agreement under Massachusetts law. ***If the agreement may be said to give the trustees unlimited discretion in this respect, so that dividends could be arbitrarily and capriciously withheld or declared, then the dividend power would reconstitute a "right" under section 2036(a)(2); if, on the other hand, the power is circumscribed by cognizable limits on the exercise of discretion, then no such "right" exists.***

Id. (emphasis added).

The Court determined that a fair reading of the trust agreement would permit the omission of the dividend (or a reduction in amount) "only if the determination to eliminate or reduce the dividend were made in good faith and in the exercise of a bona fide business judgment." *Id.* at 1026. The Court further found that while "it was within the discretion of the trustees to prefer a business opportunity over a larger dividend, . . . there is no implication that the trustees could simply forego dividends without justification." *Id.* at 1026. Thus, the Court held that

> In view of the perceived limitations on the dividend power in the trust agreement in question, and the apparent willingness of the Massachusetts courts to hold business trustees to a fair standard of conduct, we conclude that the decedent and his sons did not have the power to withhold dividends arbitrarily. Thus, they did not have an "ascertainable and legally enforceable" *right* to shift income between the classes of shareholders, and the dividend power does not require inclusion of either the common or preferred shares in the decedent's estate under section 2036(a)(2). We think *Byrum* is controlling.

Id. at 1027.

8. *Estate of Stone v. Comm'r.*

In *Stone*, 86 T.C.M. (CCH) 551 (2003), the Tax Court (Judge Chiechi) held that § 2036 did not apply to two partnerships created by Mr. and Mrs. Stone and their four children several months before Mr. and Mrs. Stone died. In *Stone*, five separate limited partnerships were funded in April of 1997. The purpose of the partnerships was to create a vehicle for managing Mr. and Mrs. Stone's assets, as well as help resolve ongoing disputes and litigation among Mr. and Mrs. Stone's four children. Each child was a co-general partner of one of four partnership holdings certain assets. A fifth partnership was also created with additional assets. The children funded their capital contribution to the partnerships through assets given to them by Mr. and Mrs. Stone. The gifts were disclosed on timely filed gift tax returns. Mr. Stone died in May of 1997. Mrs. Stone died in 1998.

The IRS originally asserted various alternative arguments to essentially ignore the existence of the partnerships. Those arguments included substance over form, lack of economic substance, gift on formation and § 2036(a)(1). The arguments other than § 2036(a)(1) were dropped before trial. In addressing the IRS's § 2036 argument, the Court opined that three elements were required: (1) a transfer of property by the decedent; (2) the transfer was other than a bona fide sale for an adequate and full consideration in money or money's worth; and (3) decedent retained possession or enjoyment of, or the right to the income from, the property transferred.

The Court's analysis focused on the second element of § 2036; that is, whether the transfers of assets to the partnerships were other than a bona fide sales for an adequate and full consideration. The Court distinguished this case from the prior decisions in *Harper*, *Reichardt, Thompson* and *Strangi*. The Court noted that the Stone partnerships were created as a results of arms-length negotiations in which each member of the Stone family (including the parents) was represented by his or her independent counsel. The Court found that the transfers to the partnerships "were motivated primarily by investment and business concerns relating to the management of certain of the respective assets of Mr. Stone and Mrs. Stone during their lives and thereafter and the resolution of the litigation among the children." The Court noted that each of the partnerships had economic substance and operated as joint enterprises for profit though which the children actively participated in the management. The Court thus held that transfers of assets to the partnerships by Mr. and Ms. Stone did not constitute a circuitous "recycling of value".

In addition, the Court found that the initial transfers to the partnerships by Mr. and Mrs. Stone did not result in gifts to the other partners. The Court noted that the partnership interests received were proportionate to the assets contributed, the assets transferred by each partner were properly credited to the partner's capital accounts, and upon termination or dissolution, the partners were entitled to distributions equal to their respective capital accounts. The IRS, on the other hand, argued that the partnership interests received by Mr. and Mrs. Stone did not constitute adequate or full consideration after taking into account appropriate discounts in the values of the partnership interest. The Court rejected this argument, stating:

> Respondent's argument in effect reads out of section 2036(a) the exception for a 'bona fide sale for an adequate and full consideration in money or money's worth' in any case where there is bona fide, arms'-length transfer of property to a business entity (*e.g.*, a partnership or a corporation) for which the transferor receives an interest in such entity (*e.g.*, a partnership interest or stock) that is proportionate to the fair market value of the property transferred to such entity and the determination of the value of such an interest takes into account appropriate discounts. We reject such an argument by respondent that reads out of section 2036(a) with the exception that Congress expressly rejected when it enacted the statute. . . . Respondent's argument about the discounted value of the partnership interest at issue also ignores the fact that each of the five partnerships were created, funded, and operate as a joint enterprise for profit for the management of its assets in which there was a genuine pooling of property and services.

Id. at 581. Thus, the Court held that IRC § 2036 did not apply because the bona fide sale for a full and adequate consideration exception was met.

9. *Kimbell v. United States.*

In *Kimbell*, 244 F. Supp. 2d 700 (N.D. Tex 2003), the IRS successfully argued at the district court level that a family limited partnership should be ignored under I.R.C. § 2036. However, this district court's decision was reversed on appeal in the Fifth Circuit. *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004), *rev'g* 244 F. Supp. 700 (N.D. Tex. 2003).

In this case, a family limited partnership was created when the principal contributor (Mrs. Kimbell) was 96 years old. Before the partnership was created, the bulk of Mrs. Kimbell's assets were held in a living trust of which she and her son served as trustees. The trust transferred the most of its assets to the partnership in exchange for a 50% interest in the LLC (which was the 1% general partner of the partnership) and a 99% limited partnership interest in the partnership. Mrs. Kimbell's son was a co-trustee of the trust and owned the other 50% interest in the LLC. The son was also the manager of the LLC.

Mrs. Kimbell died within 2½ months after the partnership was created. The IRS took the position during the audit that I.R.C. § 2036 operated to bring the assets contributed by the trust into Mrs. Kimbell's gross estate. The estate paid the tax, and filed a claim for refund. When the refund claim was denied, the estate filed suit in the United States District Court for the Northern District of Texas (Dallas Division).

Both the estate and the IRS filed cross motions for summary judgment regarding the applicability of I.R.C. § 2036 to the case. Citing *Harper v. Comm'r*, the district court held that I.R.C. § 2036 did apply to the case. Like the court in *Harper*, the district court found that the "bona-fide sale for an adequate and full consideration." Exception under § 2036 had not been met because "Plaintiff has produced no credible evidence that the formation of the Partnership was the product of an arm's length transaction, *i.e.* a transaction 'between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power' . . . Indeed, one cannot even find two parties, much less two parties conducting an arm's length negotiation leading to a bona fide sale." 244 F. Supp. at 704. The Court further found that this partnership creation was nothing other than mere "value recycling" similar to that found in *Harper*.

The district court then addressed the question of whether Mrs. Kimbell "retained the enjoyment of the property transferred to the partnership." The Court, focusing on the terms of the limited partnership agreement, noted that Mrs. Kimbell, as a 99% limited partner, could at any time remove the general partner and appoint herself or someone of her choosing to be the general partner. Moreover, the Court also found that the general partner had "sole discretion" to decide on distributions of income from the partnership. The Court thus found that Mrs. Kimbell "retained the power to either personally benefit from the income of the partnership or to designate the persons who would benefit from the income of the partnership, and thus runs afoul of both I.R.C. § 2036 (a)(1) and (2)." *Id.* at 705. The Court rejected the estate's claim that the fiduciary duties owed by the general partner prevented Mrs. Kimbell from having § 2036 retained rights, holding that (1) *U.S. v. Byrum* was "distinguishable on its facts" and was "expressly overruled by Congressional enactment of § 2036(b), and (2) regardless, the partnership agreement specifically provided that the General Partner will not owe a fiduciary duty to the Partnership or to any Partner." *Id.*

On appeal, the Fifth Circuit reversed the district court's decision. The Court held that the bona fide sale for adequate and full consideration exception precluded the application of § 2036. In its opinion, the Fifth Circuit set forth an excellent analysis of both the "bona fide sale" and the "adequate and full consideration" language of § 2036.

As to what constitutes a "bona fide sale" in the context of the creation of an entity, the Court held that "what is required for the transfer by Mrs. Kimbell to the Partnership to qualify as a bona fide sale is that it be a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest in exchange." *Id*. at 265. The Fifth Circuit noted several "objective facts" that supported the taxpayer's position that the transfer to the partnership was a bona fide sale. Those facts included:

> (1) Mrs. Kimbell retained sufficient assets outside the Partnership for her support and there was no commingling of Partnership and her personal assets;
>
> (2) Partnership formalities were satisfied and the assets contributed to the Partnership were actually assigned to the Partnership;
>
> (3) The assets contributed to the Partnership included working interests in oil and gas properties which do require active management;
>
> (4) Other credible non-tax reasons for the formation of the partnership that could not be accomplished via Mrs. Kimbell's trust, which included protection from creditors, centralized management, keeping the assets in an entity that would preserve the property as separate property for descendents, establishing a vehicle to manage the assets if something should happen to Mrs. Kimbell's son, and providing a dispute resolution mechanism.

Id. at 267.

As to what constitutes full and adequate consideration in connection with the creation of an entity, the Court held that the proper focus is:

> (1) Whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the Partnership;
>
> (2) Whether the assets contributed by each partner to the Partnership were properly credited to the respective capital accounts of the partners; and
>
> (3) Whether on termination or dissolution of the Partnership the partners were entitled to distributions from the Partnership in amounts equal to their respective capital accounts.

Id. at 266.

In finding that the creation of the Partnership was bona fide, the Court noted that "the absence of negotiations between family member over price or terms is not a compelling factor in the determination as to whether a sale is bona fide, particularly where the exchange value is set by objective factors." *Id.* at 263. The Court also noted that "tax planning motives do not prevent a sale from being "bona fide" if the transaction is otherwise real, actual or genuine." *Id.* at 264. Finally, the Court noted that preservation of family assets, including post mortem asset management issues, can constitute a valid motivating reason to form a partnership. Specifically, the Court noted that in *Church*, "preserving the family ranching business for themselves and their descendents" was valid motivating reason to form the Partnership. *Id.* at 264. Likewise, the Court noted that in *Estate of Stone*, one of the main reasons for forming the Partnership was to "currently transfer management of the parent's estate to the children, who as general managers of the Partnerships, began to actively manage the Partnerships." *Id.*

The Court did not address the § 2036(a)(1) issue. The Court addressed the § 2036(a)(2) issue with respect to the LLC. The Court held as follows:

> The 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.

Id. at 270.

The Court remanded the case to the trial court for a determination of whether an assignee interest or a limited partnership interest was transferred as a result of Mrs. Kimbell's death. The resolution of that issue could have a significant valuation impact since valuation is based upon the rights transferred under state law. An owner of the 99% limited partnership interest would have the ability under the Kimbell agreement to remove the general partner and replace the general partner with himself or herself. That would give the owner all control and most of the equity in the partnership. An assignee would have no such right. The valuation difference would likely be substantial, particularly if the limited partner had the ability to liquidate the entity. In *Estate of Jones v. Comm'r.*, 121 T.C. 21 (2001), the Tax Court found such a power limited the valuation discount to 8%.

10. *Estate of Abraham v. Comm'r.*

In *Abraham*, 87 T.C.M. (CCH) 975 (2004), Mrs. Abraham (the "Decedent") was placed under a guardianship in 1993. Six months after the guardianship was created, the guardian *ad litem* obtained court approval to establish an estate plan and to make gifts. The estate plan called for the creation of three family limited partnerships, with funds being reserved for the ward's support, and for annual exclusion gifts and sales of limited partnership interests.

A separate partnership was created for each of the Decedent's three children. The general partner of each partnership was a corporation owned by revocable trusts created for the Decedent. In the two daughter's partnerships, the Decedent received 98% limited partnership interests and each daughter received a 1% limited partnership interest. Each daughter was deemed to have contributed approximately $9,000 to her partnership. The Decedent received a 99% limited partnership interest in the son's partnership.

After creation, each daughter purchased 27% limited partnership interests in their partnerships from the Decedent for $160,000. The percentage interests were based upon an appraisal of the underlying real estate and an application of a 15% lack of control discount and 25% lack of marketability discount by a business adviser. A formal appraisal was not obtained. As time went on, each daughter purchased additional interests by paying cash into the partnerships.

The son became a 30% limited partner in his partnership by releasing his claims against the Decedent's estate. Annual exclusion gifts of limited partnership interests were also made to the children and members of their families.

The Court's decree approving the estate plan and the partnership agreements contained the following provisions: (1) the two daughters were to receive the income from their family limited partnership "either as the management fee and/or gifts from Ida Abraham after deducting from the gross income of the partnership all fees, taxes, partnership administration expenses, and reserve for expenses and monies needed in the discretion of the limited guardian *ad litem* for Ida Abraham's support;" and (2) the partnerships "shall share equally any and all costs and expenses related to [various suits] and the support of Ida Abraham so far as the funds generated by Ida Abraham's property maintained by her do not provide sufficient funds for her adequate health, safety, welfare and comfort as determined by the limited guardian *ad litem.*" (emphasis added.)

At trial, the children testified that there was an agreement that their mother's needs would be provided for out of the partnerships.

Judge Ruwe opined that the Decedent had retained sufficient rights under § 2036 to require the inclusion of the partnership assets in her estate. The Judge noted that "it is clear from the documentary evidence and the testimony elicited from trial that, regardless of the form of the decedent's transfers, she continued to enjoy the right to support and maintenance from all of the income that the FLPs generated."

Judge Ruwe further opined that the bona fide sale for adequate and full consideration exception had not been met. The Court noted that "clearly, decedent did not receive any consideration for the gifted interests." As to the $160,000 paid by the daughters to the Decedent for their 27% interests, the Court held that the daughters' payments did not constitute full and adequate consideration because the estate had not met its burden to show, through the introduction of an expert report or testimony, that the discounts were reasonable or that full consideration was paid for the purchased interests. As to the interests purchased by the daughters in return for payments to the partnerships, the Court reasoned that payments could not be treated as consideration because they were not paid "to the Decedent." As to the 30% interest acquired by the son in exchange for his release of claims against the Decedent's estate, the court did not address the issue of whether the transfer was for full and adequate consideration because the IRS only included 70% of the fair market value of the son's partnership in the Decedent's estate.

The First Circuit Court of Appeals affirmed the Tax Court's opinion. As to whether § 2036 applied to the partnership interests transferred by the Decedent, the court noted that

> The biggest hurdle in the way of the Estate (and the reason why it lost in the Tax Court) is that it did not meet its burden of proof that Donna and Diana paid adequate consideration for their FLP interest. The Estate produced no admissible evidence concerning the adequacy of the discounted value of the FLP percentage interests because the valuation letters from Kirchick, on which the Estate relies, were excluded from evidence for those purposes. The Estate does not challenge that evidentiary ruling by the Tax Court here.

Thus, the court held that the transfer of interest did not satisfy the bona fide sale for full and adequate consideration exception to § 2036.

As to retained rights under § 2036(a)(1), the court noted that while the partnership agreements themselves did not include Mrs. Abraham's support as an obligation of the partnerships, the evidence at trial demonstrated that all parties understood that the guardian ad litem had the discretion and the approval of the family to use all of the partnership income, if necessary, for Mrs. Abraham's support and the guardianship court decree provided similarly. Likewise, the court noted that the guardian ad litem failed to segregate Mrs. Abraham's personal funds from the funds in her revocable trust and commingled monies in the bank accounts for the partnerships.

11. *Estate of Hillgren v. Comm'r.*

In *Hillgren*, 87 T.C.M. (CCH) 1008 (2004), Lea Hillgren (the "Decedent") had been involved in real estate business with her brother ("Hillgren") in the decade before her death. In April 1994, the Decedent and Hillgren entered into a Business Loan Agreement ("BLA"). The BLA basically encumbered real estate as collateral for fulfillment of the decedent's obligations to Hillgren. Under the BLA, Hillgren had the sole right to determine if and when any of the properties subject to the agreement would be sold during the 29-year BLA period.

On January 1, 1997, the Decedent and Hillgren formed a limited partnership. The partnership also had a term of 29 years. In exchange for her contribution of properties to the partnership, the Decedent received a 99.95% capital interest and a 75% profit interest. At formation, the Decedent gave Hillgren a .05% capital interest and a 25% profit interest. The Decedent contributed seven pieces of real estate to the partnership, four of which were encumbered by the BLA.

The Decedent, however, did not transfer legal title of the properties to the partnership. The contribution was simply reflected on the partnership agreement. The leases on the contributed property were also not assigned to the partnership before the Decedent's death. The leases remained in the Decedent' name or in the name of her d/b/a. Partnership business could be, and was, conducted without disclosing the existence of the partnership. Partnership transactions with respect to the properties (such as leases, maintenance contracts, and payment of taxes) occurred the name of the Decedent's d/b/a. On May 27, 1997, the Decedent executed quit claim deeds transferring her interests in the partnership properties to a trust. She also assigned her partnership interests to the trust. The deeds were unrecorded at the time of her death.

The partnership did not have a dedicated bank account during the Decedent's lifetime. Partnership financial statements included the Decedent's residence, the mortgage on her residence, and the mortgage and property tax payments on the residence. The distributions made by the partnership during 1997 were made specifically to enable the Decedent to pay her living expenses, and she was dependent upon the cash flow of the partnership to cover her personal expenses. The partnership also paid the costs of estate including estate taxes and administration expenses.

In the memorandum opinion, the Tax Court held that I.R.C. § 2036 applied to the assets contributed to the partnership. The Court noted that the stated purpose for forming the partnership between audit (where the estate claimed that it was formed for asset protection purposes) and trial (where the estate claimed that it was a pre-marital asset protection device) were inconsistent. But the Court focused on formation and operational defects in holding that § 2036 (a)(1) applied. In essence, the Court found a basic failure to respect the partnership as a separate entity through (1) the failure to transfer assets to the entity, (2) representations made to third parties, including a mortgage broker and a lender, that the Decedent owned and remained in control of the properties, (3) the fact that the Decedent had received and was dependent upon the cash flow from the partnership for her living expenses, (4) the partnership's failure to file a certificate of limited partnership until the examination of the estate tax return began, (5) the lack of formality surrounding the partnership, (6) the intention of the parties to keep the agreement largely invisible, (7) the apparent disregard of the agreement as situations arose, (8) the restatements of the financial affairs by Hillgren and representatives of the estate, and (9) the inconsistent positions taken on the estate tax return and the partnership's tax returns (the estate tax return reported that Hillgren had 25% profits interest [reducing value] and the partnership tax return reported that Hillgren had a .05% profit interest [reducing Hillgren's taxable income], a discrepancy that was not fixed until after the examination of the estate tax return had begun).

Although the Court disregarded the partnership, all was not lost for the taxpayer. In determining the valuation effect of the BLA on the properties of the estate, the Court opined that it had a significant effect on value because of its impact on the control and marketability of the properties. The Court opined that 50% discount for lack of control and lack marketability should be applied.

12. *Estate of Bongard v. Comm'r.*

In 1980, Wayne Bongard formed Empak, a Minnesota corporation that designed and manufactured plastic products for the semiconductor and data storage industries. Mr. Bongard was the sole shareholder until 1986, when he created an irrevocable trust for the benefit of his children and stepdaughter ("the ISA Trust"), and funded it with 15% of his shares of Empak stock.

In January of 1996, Mr. Bongard and the ISA Trust formed a limited liability company, WCB Holdings, LLC ("WCB Holdings"). WCB Holdings was formed to consolidate the Bongard family Empak stock in one holding company to position Empak for a liquidity event, either a merger or a private or public offering of stock.

On December 28, 1996, Mr. Bongard and the ISA Trust each transferred their shares of Empak stock to WCB Holdings. Mr. Bongard received an 86% interest in the voting and non-voting WCB Holdings member units and the ISA Trust received a 14% interest in the voting and non-voting WCB Holdings member units. The next day, Mr. Bongard and the ISA Trust each contributed a portion of their non-voting WCB Holdings membership units to a family limited partnership (the "Partnership"). Mr. Bongard received a 99% limited partnership interest and the ISA Trust received a 1% general partnership interest in exchange for the contributions.

Mr. Bongard also created three additional trusts for the benefit of family members, and funded the trusts with gifts of voting WCB Holdings member units. These gifts reduced Mr. Bongard's voting interest in WCB Holdings below 50%.

On December 10, 1997, Mr. Bongard transferred a 7.72% limited partnership interest to his wife and at the same time, entered in a post-martial agreement. On November 16, 1998, Mr. Bongard died unexpectedly of a heart attack while in Austria. He was 58 years old at the time of his death.

After an estate tax audit, the IRS issued a $52.9 million estate tax notice of deficiency to the Estate, arguing that the Empak stock transferred to WCB Holdings should have been included in Mr. Bongard's gross estate and that both WCB Holdings and the Partnership should be ignored under I.R.C. §§ 2036 and 2038. Before trial, the IRS dropped the § 2038 argument and attempted to increase the deficiency to $100 million.

The case was reviewed by the entire Tax Court, with the majority opinion being written by Judge Goeke. Addressing the IRS's § 2036 argument, the initial issue for the majority to decide was whether the creation of WCB Holdings and the Partnership qualified as a "bona fide sale for adequate and full consideration." The majority concluded that each element of the test is satisfied if (1) there is "a legitimate and significant non-tax reason" for the creation of the entity, and (2) the interests received are proportionate to the value of the property contributed to the entity. The majority stated that the "significant purpose must be an actual motivation, not a theoretical justification." The majority further noted that "legitimate non-tax purposes are often inextricably interwoven with testamentary objectives."

As to WCB Holdings, the majority concluded that the creation of WCB Holdings in anticipation and in furtherance of a corporate desire to pursue a liquidity event was a legitimate and significant non-tax reason for creating the entity. Thus, the majority determined that the creation of WCB Holdings was the result of an arm's length transaction and was bona fide.

The majority concluded that the adequate and full consideration component was satisfied because Mr. Bongard and the ISA Trust each received an interest in WCB Holdings in proportion to the value of the assets contributed, that their respective capital accounts were properly credited with the contribution, and that distributions from WCB Holdings required a negative adjustment in the distributee's capital account. Thus, the majority held that the stock transferred to WCB Holdings was not includable in Mr. Bongard's gross estate because the bona fide sale for adequate and full consideration exception to § 2036(a) was satisfied.

With respect to the transfer of non-voting WCB Holdings units to the Partnership, the majority determined that the transfer of WCB Holdings units was not motivated by legitimate or significant non-tax reasons. Although the evidence at trial demonstrated, and the IRS did not dispute, that the non-tax reasons for the creation of the Partnership included (1) the desire for the Partnership to serve as a family investment vehicle once the liquidity event occurred, (2) creditor protection, (3) facilitation of the post-marital agreement with Mr. Bongard's wife, and (4) greater flexibility than a trust, the majority opined that because the Partnership never invested or diversified its assets following Mr. Bongard's contribution of WCB Holdings units, the non-tax reasons were not legitimate or significant.

The majority further opined that Mr. Bongard's practical control over the Partnership (through his positions as the Chief Executive Officer and sole Board Member of Empak) constituted an understanding among the parties involved that Mr. Bongard retained the right to control WCB Holdings units transferred to the Partnership. Accordingly, the majority held that § 2036(a)(1) included the value of WCB Holdings units held by the Partnership on Mr. Bongard's death proportionate to his 91% limited partnership interest. The majority also held that the gross estate included the value of WCB Holdings units held by the Partnership that was proportionate to the 7.72% limited partnership interest transferred to Mr. Bongard's wife due to the application of § 2035(a).

In a concurring opinion, Judge Laro opined that the adequate and full consideration exception should apply "only where the transferor's receipt of consideration is of a sufficient value to prevent the transfer from the pleading to transferor's gross estate." In another separate concurrence, Judge Halpern opined that the majority had incorporated an "inappropriate motive test" into the bona fide sale exception. Concurring in part and dissenting with respect to the application of § 2036(a)(1) to the WCB Holdings, Judge Chiechi opined that the majority was wrong to hold that there was an implied agreement that allowed Mr. Bongard to retain enjoyment of the Partnership property, noting that the reason the Partnership never invested or diversified its assets following Mr. Bongard's contribution of WCB Holdings units to the Partnership was he died before the liquidity event could occur. Judge Chiechi also noted that the majority decision to apply § 2036 to WCB Holdings because of Mr. Bongard's alleged "control" was contrary to the Supreme Court's decision in the *Estate of Byrum v. United States,* 408 U.S. 125.

13. *Estate of Bigelow v. Comm'r.*

In *Bigelow*, T.C. Memo 2005-65 (March 30, 2005), Virginia Bigelow created a revocable trust in 1991 ("the Trust") and transferred her residence to the Trust. Mrs. Bigelow's son was the Co-Trustee of the Trust and her agent under a durable power of attorney. In 1992, Mrs. Bigelow suffered a stroke and moved out of the house. In 1993, the Trust exchanged the residence for other rental property, and borrowed $350,000 secured by the new rental property to pay off prior loans that had been secured by the residence. Later that year, the Trust obtained a $100,000 line of credit secured by the rental property, and the Trust drew down $100,000 over the next year and made gifts of some of that amount to Mrs. Bigelow's children and grandchildren.

In December of 1994, the Trust contributed the investment property to a family limited partnership ("the Partnership"). At this time, Mrs. Bigelow was 85 years old and living in an assisted living facility. The $450,000 of liability secured by the property, however, remained as a liability of the Trust and was not transferred to the Partnership. The Trust was the sole general partner, and received most of the limited partner units. The children each contributed $100 for a very small limited partnership interest. After the transfer, Mrs. Bigelow was left with an insufficient amount to meet her living expenses or to satisfy her liability for the indebtedness.

Despite the fact that the loan was not an obligation of the Partnership, the Partnership made the principal and interest payments and paid some of Mrs. Bigelow's living expenses. The son, as agent for Mrs. Bigelow, made 40 transfers between the Partnership and the Trust during a period of approximately 2 years.

During 1994 and 1995, the son (again using the power of attorney) withdrew some of the Trust units and the Partnership and made gifts to himself and his sisters and to Mrs. Bigelow's grandchildren. Gift tax returns were not filed until after Mrs. Bigelow passed away.

Mrs. Bigelow died in August of 1997 at the age of 87. At the time of her death, the Trust owned a 1% general partnership interest and a 45% limited partnership interest in the Partnership. The Partnership was terminated during 1998. The Estate claimed a 31% lack of marketability discount in the gifts of the limited partnership units and a 37% lack of marketability discount on the value of the limited partnership interests owned by the Trust at the time of Mrs. Bigelow's death.

The IRS asserted in the Notice of Deficiency that § 2036(a)(1), (2) and § 2038(a)(1) applied. The deficiency asserted was $217,000.

The Tax Court (Judge Colvin) agreed that § 2036(a)(1) applied to the assets contributed by the Trust to the Partnership, finding an implied agreement that Mrs. Bigelow would retain the income from and the enjoyment of the rental property that was contributed. The court noted that the Partnership made the payments on the $350,000 loan that was owed by the Trust and the Partnership also made distributions to fund Mrs. Bigelow's living expenses. No distributions were made to any other partner. The court also noted that the investment property continued to secure Mrs. Bigelow's personal obligations on the $450,000 worth of liabilities, and that constituted retained enjoyment of the property contributed to the Partnership.

The court further held that the bona fide sale exception to § 2036 did not apply because the transfers to the Partnership were not in good faith and were not made for legitimate non-tax purposes. The court further noted that the parties failed to respect partnership formalities, including (1) a failure to maintain partnership capital accounts, (2) the balance sheets improperly reflected the $350,000 liabilities or liability to the Partnership, (3) K-1's did not properly reflect capital accounts, (4) the Trust's capital account was not adjusted to reflect payments on a $350,000 loan made by the Partnership as required by the partnership agreement, and (5) Mrs. Bigelow's capital account never reflected the value of the Trust contribution of the rental property. At bottom, the court found that the Bigelows did not comply with the terms of the partnership agreement.

The court also held that the transfer did not provide and there was no potential to provide non-tax benefits to Mrs. Bigelow as a result of the creation of the entity "because management of the assets did not change as a result of the transfer and there was no pooling of assets." The non-tax purposes for creating the Partnership relied upon by the Estate included (1) creditor protection, (2) continuity of management, and (3) gifting efficiency. The Court distinguished each of these. First, the court opined that no additional creditor protection was provided because Mrs. Bigelow's Trust was the sole general partner and the general partner was not protected from liability associated with the rental property. Second, the court noted that there was no change in the continuity of management because the Partnership would terminate when the Trust terminated as the Trust was the general partner. Third, the court opined that gifting efficiency was not a sufficient non-tax reason because "a transfer made solely reduced taxes and to facilitate gift giving is not considered in this context to be made in good faith or for a bona fide purpose."

Finally, the court distinguished the facts of the *Bigelow* partnership from the *Kimbell* partnership, noting that the Trust did not part with all of its interest in the rental property because the property continued to secure the obligation to Mrs. Bigelow, there was no potential benefits of the Trust from creating the Partnership and the Partnership interest received by the Trust was not equivalent to the rental property, the *Kimbell* partnership shielded the decedent from liability because there was an LLC general partner, Mrs. Kimbell retained $450,000 in assets outside of the partnership for her support and did not make continuous transfers between her personal assets and the partnership assets.

14. *Estate of Korby v. Comm'r.*

In *Korby*, 89 T.C.M. (CCH) 1150 (2005), Austin and Edna Korby, while in poor health, transferred almost all of their assets (other than their residence and their right to social security checks) to a family limited partnership and immediately gave their 98% limited partnership interests to trusts created for their 4 sons. Distributions were made to the Korbys to provide for their nursing home care, medical expenses, and other living expenses. In fact, only the Korbys' (and not the trusts who owned 98% of the interests) received distributions during the remainder of the Korbys' lives. The court rejected the estate's claim that the distributions were simply management fees paid to the husband for managing the partnership assets. The court applied § 2036(a)(1) to include the partnership assets and the Korbys' gross estate, finding that the creation of the partnership was a "testamentary vehicle designed to transfer [their] assets to their sons during their lives at a significant discount, while retaining . . . the economic enjoyment of those assets. The court determined that the bona fide sale for full and adequate consideration exception did not apply, primarily because (1) the Korbys were financially dependent upon distributions from the partnership, and (2) Mr. Korby had created the partnership with no input from any of the other partners (although his sons did not receive their partnership interest until after the entity was created).

On December 8, 2006, the 8th Circuit Court of Appeals affirmed the Tax Court's decision. *Estate of Korby v. Comm'r.*, 471 F.3d 848 (8th Cir. 2006). The 8th Circuit found no clear error in the Tax Court's determination that an implied agreement existed between the Korbys and their four sons which allowed Mr. and Mrs. Korby to retain the right to the income from the partnership after its initial funding.

The Court noted that the significant payments made by the partnership to the Korby's living trust over the remainder of their lifetimes, the lack of a written management contract between the living trust and the partnership, Mr. Korby's failure to keep track of the hours spent managing the partnership, the manner in which the payments were made, and Mr. Korby's failure to report the payments as self employment income all supported the Tax Court's rejection of the Korby's management fee claim. The Court also noted that the Korbys' retention of less than $10,000 in assets in the living trust (their only source of income) following the funding of the partnership, the logical expectation that they would incur living expenses beyond the social security they were expected to receive, and the Korbys' poor health were factors supporting the § 2036(a)(1) "retained right to income" finding of the Tax Court.

The 8th Circuit also found no clear error in the Tax Court's finding that the partnership did not satisfy the *bona fide* sale for adequate and full consideration exception. Citing the 3rd Circuit's decision in *Estate of Thompson*, the Court noted that "the transaction must 'be made in good faith' which requires an examination as to whether there was 'some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form.'" Factors the Court noted as important with respect to the *bona fide* sale finding included the following: the partnership was formed by Mr. Korby with the help of his estate planning lawyer and without the involvement of his sons, who were unfamiliar with the terms of the partnership agreement; Mr. Korby decided alone what assets would be included in the partnership; and Mr. and Mrs. Korby continued to have access to the income from those assets transferred to the partnership during their lives.

15. *Estate of Schutt v. Comm'r.*

In *Schutt*, T.C. Memo 2005-126 (May 26, 2005), the Tax Court (Judge Wherry) addressed the application of § 2036 to two Delaware business trusts created a year before the decedent's death between the decedent and the Wilmington Trust Company (who served as the trustee of seven trusts held for the benefit of the decedent's children and grandchildren). One of the business trusts held DuPont stock, and the other held Exxon stock. More than 50% of the contributions to each Delaware business trust came from the seven trusts managed by Wilmington Trust. The primary purpose for creating the Delaware business trusts was to preserve the decedent's buy and hold philosophy with regard to the DuPont and Exxon stock. In particular, the DuPont stock and the Exxon stock (and its predecessor) had also been held by the family for many years. Entity formalities were adhered to and there was no commingling of personally owned assets and the assets owned by the Delaware business trusts. The decedent retained substantial assets outside of the trusts. The decedent was the trustee of the trusts, which akin to holding the position of a general partner.

In addressing the IRS's argument that both § 2036(a)(1) and (a)(2) should be applied to the assets of the business trusts, the court focused on the "bona fide sale for full and adequate consideration" exception. The court examined the test under both the "legitimate and significant non-tax reason" standard set forth in *Bongard* and the Third Circuit's references in

Turner for the need for some potential benefit to the transferor other than estate tax benefits. The court held that objective evidence, both in the form of contemporaneous documentation and testimony, supported the Estate's position that a significant motive for the creation of the business trusts was to the perpetuation of the decedent's buy and hold investment philosophy and that this motive was a "legitimate and significant non-tax reason" within the meaning of *Bongard*. The court distinguished the *Schutt* entities from the fact, in *Turner*, where the Third Circuit court noted that the mere holding of an untraded portfolio of marketable securities is generally a negative factor in assessing the potential non-tax benefits resulting from a transfer to a family entity, noting that the creation of the business trusts allowed Mr. Schutt to impose his specific buy and hold investment philosophy on the very substantial assets contributed by the Wilmington Trust Company Trusts.

16. *Estate of Rosen v. Comm'r.*

In *Rosen*, T.C. Memo 2006-115, the Tax Court addressed the application of § 2036 to a limited partnership created four years before the decedent's death. At creation, the decedent transferred $2.4 million of cash and marketable securities to the partnership in exchange for a 99% limited partnership interest. Her son and daughter transferred approximately $12,000 each for a .5% general partnership interest. The partnership was created after her son-in-law, who is an attorney, attended the seminar in family limited partnerships and concluded from the seminar that the assets should be transferred to a partnership to reduce the value of her estate for federal estate tax purposes. Several years before the partnership was formed, the decedent had been diagnosed as unable to manage her affairs. Before her death, the decedent had given to her children, grandchildren, and certain trusts approximately 64% of her limited partnership interest. At the time of her death, the decedent's revocable trust owned a 35% limited partnership interest.

The first issue addressed by the court was the bona fide sale for adequate and full consideration exception to § 2036. The court found that the primary reason for creating the partnership was to avoid federal, estate and gift taxes and neither decedent nor her children had any legitimate or significant non-tax reason for creating the entity. The court ignored the estate's assertion that the following four legitimate significant non-tax reasons existed for creating the partnership: (1) to protect the decedent's assets during her life time, and ultimately provide limited liability protection to the donees of the interests; (2) to create giftable assets that preserve value and cannot easily be liquidated in the short term; (3) to facilitate the decedent's annual giving program to her family members; and (4) to provide for the common management of the partnership's assets during the decedent's lifetime and after her death. The court was unpersuaded that the decedent's creditors would not have been able to foreclose on substantially all of the decedent's assets transferred to the partnership or that the partnership would have withstood the scrutiny of the bankruptcy court. The court further held that facilitation of a gift giving program was not a significant nontax purpose and that the decedent's irrevocable trust already provided for the common management of her assets.

The court listed a number of objective facts that supported its conclusions that the transfer of assets to the partnership was not bona fide, including (1) the partnership was not engaged in a valid, functioning business operation and served no legitimate or significant nontax purpose; (2) the partners did not negotiate or set any of the terms of the partnership agreement and the decedent's daughter as the decedent's attorney-in-fact, the co-trustee of her irrevocable trust, and the general partner of the partnership stood on all sides of the transaction; (3) initial contributions to the partnership were made more than three months after the partnership agreement was signed and the contributions of the decedent's children were *de minimus* in relation to the assets contributed by the decedent; (4) the decedent, acting through her daughter, transferred substantially all of her assets to the partnership; (5) after the transfer of assets to the partnership, the decedent was unable to meet her financial obligations without using funds of the partnership; (6) the assets contributed to the partnership consisted solely of marketable securities and cash; and (7) the decedent was 88 years old in failing health when the partnership was created.

Addressing the retained rights under § 2036(a)(1), the court found that it was understood that the decedent would receive distributions when and as she needed them, noting that (1) the partnership used assets received from the decedent to pay indirectly the same types of expenses and conduct the same gift giving as before the transfer; (2) funds of the partnership were used to pay the decedent's living expenses, to make gifts to her decedents, and to pay the bequests under her irrevocable trust and the expenses of her estate, including estate taxes; (3) the decedent's assets were transferred to the partnership on the advice of counsel in order to minimize the tax on the passage of her estate to her descendants. Thus, the court held that the assets transferred by the decedent to the partnership should be included in her estate under § 2036(a).

* * * * *

Factors examined by the courts in deciding whether § 2036 applies are case specific and continue to be developed through litigation and in the appeals of decisions such as *Strangi* and *Thompson.* "Formation" facts looked at by the courts have included: (1) the non-tax reasons for creating the entity; (2) whether the other partners made real contributions of property or services; (3) whether the decedent had sufficient assets outside of the partnership to live on; (4) whether personal use assets were placed in the partnership; (5) whether fiduciary obligations were negated in the partnership agreement; (6) whether partners other than the decedent had the opportunity to comment on and provide input with respect to the terms of the partnership agreement; (7) whether partners other than the decedent had the opportunity to decide what assets would be contributed to the partnership; and (8) the discretion regarding distributions provided to the decedent general partner. "Operational" facts looked at by the courts include (1) whether the non-tax reasons for creating the entity are consistent with how it was operated; (2) whether partnership assets were commingled with the decedent's personal assets; (3) whether distributions were made in accordance with the terms of the partnership agreement; (4) whether the entity was treated and respected as a separate entity; and (5) whether personal expenses of the decedent were paid from the partnership or whether distributions were made for personal needs; (6) whether estate taxes and administration expenses were paid directly from the partnership.

IV. RECENT VALUATION CASE LAW.

A. *Estate of Dailey v. Comm'r*.

In *Dailey*, 82 T.C.M. (CCH) 710 (2001), the Tax Court addressed the fair market value of limited partnership interests in Dailey Family Limited Partnership transferred by Mrs. Dailey during her life and at her death. The assets of the partnership consisted of $1,047,603 of marketable securities, primarily Exxon stock. The Tax Court found the testimony of the IRS's expert, who applied discounts ranging from 13.51% to 15.72%, contradictory and unsupported. The Court concluded that an aggregate combined lack of control and lack of marketability discount of 40%, as espoused by the Taxpayer's expert, was warranted.

B. *Lappo v. Comm'r*.

In *Lappo*, 86 T.C.M. (CCH) 333 (2003), taxpayer made three gifts of limited partnership interests in a partnership holding marketable securities (primarily municipal bonds) and real estate. The April, 1996 gifts consisted of a 66.80917% limited partnership interest to a trust, and four .6680917% limited partnership interests to grandchildren. The July, 1996 gift was a 29.2184632% limited partnership interest to taxpayer's daughter.

The experts and the Court used the net asset value approach to determine the fair market value of the transferred interests, and reduced the proportionate net asset value by discounts for lack of control and lack of marketability. The parties disagreed as to the appropriate size of the lack of control and lack of marketability discounts.

The lack of control discount was determined by the Court using a weighted average of the individual discount factors for each category of assets owned by the partnership (*i.e.*, marketable securities and real estate). In determining the appropriate lack of control discount, both parties' experts applied the closed-end fund analysis in determining the marketable securities component of the lack of control discount. The parties agreed to use the IRS's slightly higher net asset values for the marketable securities. The IRS's expert determined a 9.5% lack of control discount for this component. The taxpayer's expert determined a 7.5% discount for this component. The Tax Court (Judge Thornton) stated that "fairness" dictated that since the parties agreed to use the IRS's slightly higher NAVs for marketable securities, that the IRS's 8.5% minority interest discount should be using in valuing in determining the lack of control discount for this component.

In determining the lack of control discount for the real estate component of the partnership portfolio, the taxpayer's expert relied on the discounts observed in the sales of interests in real estate limited partnerships. The Court noted that none of the real estate partnerships were comparable to the partnership's portfolio of real estate. Therefore, the Court focused on the lack of control discount by reference to comparable real estate investment trusts. Taking guidance from academic studies on private placement discounts, the Court concluded that a 17.6% liquidity premium would be warranted in connection with real estate investment trusts, resulting in a 19% minority interest discount for the partnership's real estate component. Applying the weighted averages of the lack of control discount factors, the Court held that an overall lack of control discount of 15% was appropriate in determining the value of the transferred limited partnership interests.

In determining the appropriate lack of marketability discount, the Court relied on private placement analyses prepared by Mukesh Bajaj and Hertzel & Smith (which the median discount observed was 21%) and concluded, based on partnership specific factors, that a 24% lack of marketability discount should be used to value the transferred interests. Applying the lack of control and lack of marketability discount sequentially, the Court reduced the proportionate net asset value by combined discounts for lack of control and lack of marketability of approximately 35.4%.

C. *Peracchio v. Comm'r*.

In *Peracchio*, 86 T.C.M. (CCH) 412 (2003), Taxpayer transferred limited partnership interests in a family limited partnership to a family trust in two separate transactions. In the first transaction, the taxpayer transferred a 45.47% limited partnership interest by gift. In the second transaction, the taxpayer transferred a 53.48% limited partnership interest to the trust in exchange for a promissory note in the amount of $646,764 (which taxpayer believed was the fair market value of the transferred interest). The transactions occurred on the same day. The taxpayer reported the fair market value of the transfers based upon a combined 40% discount from net asset value for lack of control and lack of marketability.

In the notice of deficiency, the IRS argued that the partnership lacked economic substance and should be disregarded for gift tax purposes, the partnership agreement should be treated as a restriction on the right to sell or use the property of the partnership which should be disregarded under § 2703, that the provision in the partnership agreement restricting a limited partner's ability to liquidate his interest should be treated as an applicable restriction under § 2704(b) which must be disregarded in determining the gift tax value of the transferred interests, and that no discounts for lack of control and lack of marketability were warranted. At trial, the IRS abandoned the first three arguments and modified its position with respect to the valuation argument to "allow" for a 4.4% discount for lack of control and a 15% discount for lack of marketability based upon the IRS's experts' valuation opinion.

The Tax Court (Judge Halpern) found that the parties use of publicly traded, closed-end mutual funds was an appropriate method by which to determine the lack of control discount. The Court used the weighted mean discount from a representative sample of closed-end funds and determined that a 6% lack of control discount was appropriate. The Court also concluded that a 25% lack of marketability discount was warranted in valuing the interest transferred, which represented the upper limit of the IRS's range of justifiable discounts. The combined discount for lack of control and lack of marketability applied was 29.5%.

D. *Estate of Deputy v. Comm'r.*

In *Deputy*, 85 T.C.M. (CCH) 1497 (2003), the Tax Court determined the value of a 19.99% stock holding in a corporation in the business of manufacturing aluminum boats. The decedent had made gifts of small portions of the stock within a year of her death and had transferred a 19.99% interest to a family limited partnership less than two months before her death. The stock constituted roughly 90% of the assets of the family limited partnership.

The parties resolved all issues before trial except for the value of the stock. In determining the fair market value of the stock, the taxpayer's expert relied primarily on the asset-based approach. The taxpayer's expert also used a capitalized income method, but did not rely on it since it produced a value that was less than his net asset value approach. The I.R.S.'s expert did not use the asset-based approach because the corporation "had been engaged in the manufacture and sale of boats since 1958 . . . [and] is clearly an established and successful operating company." *Id.* at 1503.

The Tax Court agreed with the I.R.S.'s expert that the income approach was the appropriate valuation approach to be used. The Court did not accept the asset-based approach because of the corporation's intangible assets, which the Tax Court identified as "good worker relationships, extensive and loyal dealer marketing relationships, and good reputation for product and service." The Court used a weighted average of 1994-1997 earnings, with 1997 earnings being weighted four times as much as 1994 earnings. The Court also used the I.R.S.'s expert's 10% capitalization rate, noting that the expert had "provided explanations supporting his conclusions and assumptions" and that the taxpayer's numbers were "without empirical support or explanation and appeared to be purely subjective." *Id.*

As to the discounts, the I.R.S.'s expert applied no lack of control discount, reasoning that the capitalized earnings approach would result in treating all interests in the entity equally and that the minority interest would receive the same percentage return as a majority investment. He applied a 25% discount for lack of marketability discount based on two restricted stock studies (FMV and Management Planning).

The taxpayer's expert arrived at a 44% combined discount for lack of control and lack of marketability using a matrix constructed by his firm. The matrix assigned a numeric discount amount to (1) information availability and reliability; (2) investment size; (3) company outlook, management, and growth potential; (4) ability to control; (5) any restrictions on transferability, anticipated holding period, and company's redemption policy; and (6) dividend payout history and outlook.

The Tax Court did not accept the I.R.S.'s expert's view that no lack of control discount should be applied. The Court was not thrilled with the taxpayer's expert's methodology either. However, the Court used the taxpayer's expert's matrix approach "as a guide to assist in our analysis of the facts presented in the record," and ultimately determined that a 30% combined discount for lack of control and lack of marketability was appropriate in valuing the stock.

E. *Estate of Green v. Comm'r.*

In *Green*, 86 T.C.M.(CCH) 758 (2003), at issue was the fair market value of stock in Royal Bank, Inc. shares. Decedent owned 5.09% of the outstanding shares, which constituted the fifth largest holding of RBI shares by one shareholder. After determining the enterprise value of the entity, the Tax Court (Judge Michael Thornton) applied a lack control discount of 17% and a lack of marketability discount of 35%.

At trial, the IRS's expert had determined a lack of marketability discount of 25%. The Taxpayer's expert determined a lack of marketability discount of 40%. Both relied on the restricted stock studies in determining the lack of marketability discount. The Taxpayer's expert also relied on the pre-IPO studies. The Court noted that the IRS's expert relied heavily on the

Management Planning, Inc. study determining the lack of marketability discount. The Court noted that the MPI study "indicates a clear correlation between the size of the company's gross income and the size of the lack of marketability discount" and the correlation was admitted by the IRS's expert. The Court noted that because the company had gross income at the low end of the range indicated in the MPI study, "we might expect the appropriate discount for RBI to be higher than the overall average lack of marketability discount of 30.8% indicated for the relevant grouping of companies." *Id.* at 765. The Court applied a 35% lack of marketability discount.

While each valuation case is dependant upon its own facts, the important point here is that Judge Thornton also examined the MPI studies in his *Lappo* decision. In *Lappo*, Judge Thornton limited the lack of marketability discount to 21%, primarily because he excluded thirteen of the private placement sales from the MPI analysis on the grounds that those involved "high tech" companies that purportedly differed from the subject interest. He did not do so in *Estate of Green*, despite the fact the bank is clearly not considered a "high tech" company.

F. *Estate of Thompson v. Comm'r.*

In *Thompson*, TC Memo 2004 - 174 (July 26, 2004), at issue was the fair market value of 487,440 shares of the voting common stock of Thomas Publishing Co., Inc. ("TPC"). The taxpayer's value of the shares in the estate tax return was based upon a valuation report prepared by an Alaskan lawyer and an Alaskan accountant. These "appraisers" determined the value of the decedent's 20% interest in TPC to be $1,750,000. On audit, the government hired a valuation expert who determined the value of the 20% interest to be $35,273,000. The IRS assessed a notice of deficiency based upon this value and also assessed an accuracy-related penalty.

The Tax Court (Judge Swift) found both the estate's and the government's experts to be deficient and unpersuasive in calculating the fair market value of the stock. The Court noted that "the estate, the executors of the estate, and the underlying company, the stock of which is being valued, were all headquartered and based in the New York City metropolitan area, but the estate hired a lawyer and an accountant from Alaska, both with relatively little valuation experience, to value the estate's 20% interest in TPC." The Court further noted that "although we admitted into the evidence the estate's valuation reports and treated them as credible, we regard those reports and the testimony of the estate's experts to be only marginally credible. Goerig and Wichorek were barely qualified to value a highly successful and well-established New York City-based company with annual income in the millions of dollars." The Court also criticized the government's valuation expert, noting that "respondent's expert appeared to be concerned with numbers only and did not appear to make an effort to base his valuation of TPC on a real company. His sterile approach is reflected both in his comparable company analysis and in his discounted cash flow analysis."

In a final analysis, the Court concluded that the valuation of the company should be based upon a capitalization of net income approach using a capitalization rate of 18.5%. The Court further applied a 15% minority interest discount and a 30% lack of marketability discount. With respect to the lack of marketability discount, the Court noted that "but for the fact that respondent's expert allowed a 30% discount for lack of marketability, we might have been inclined to reduce this discount." The Court based this view on the fact that there was a significant outside TPC shareholder who already owned a relatively large, minority block of TPC stock and TPC had a practice, which it planned to continue in the future, of paying substantial cash dividends which would allow a holder of a 20% interest to recover annually, based upon prior year dividends paid, in excess of one quarter of a million dollars. This author who note, however, that a $250,000 dividend would result in an approximately 2% yield on the Court's final conclusion of value, which was $13,000,000.

The Court declined to impose an accuracy-related penalty despite the fact that the value reported was less than 25% of the value determined. The Court found that the valuation of the block of stock was particularly difficult and unique and that comparable companies to TPC were not found. The Court also believed that noteworthy and relevant that "even respondent's expert made significant errors in his valuation calculations."

G. *Jelke v. Comm'r.*

Frazier Jelke died on March 4, 1999. Among the assets of his estate was a 6.44% interest in a closely held C Corporation whose assets consisted of a diversified portfolio marketable securities. At the time of Mr. Jelke's death, there was no intent to completely liquidate the corporation. In determining the fair market value of the 6.44% interest, the court addressed the appropriate discounts for (1) unrealized capital gains, (2) lack of control, and (3) lack of marketability.

In addressing the unrealized capital gains discount, the court declined to apply the dollar for dollar unrealized capital discount asserted by the taxpayer's expert (i.e. the total capital gain which would be incurred if all of the corporation's securities had been sold on the valuation date). Following the analysis of the government's expert, the court used the corporation's 5.95% average annual turnover rate during the five years preceding the valuation date and determined that the corporation's $51.6 million capital gain tax liability would be incurred over a 16.8 year period (100% divided by 5.95%). The court divided the $51.6 million tax liability by 16.8 years to arrive at the average annual capital gain tax liability which would have been incurred each year ($3,266,680.25) ($51.6 million divided by 16.8). The court discounted the annual cost to present value using a discount rate of 13.2%. The total discount from net asset value was $21,082,226.00. This resulted in an overall 11.2% reduction in value for built in capital gains tax liability.

The taxpayer's expert applied a 25% discount for lack of control ("LOC"). The taxpayer's expert relied on fifteen domestic equity funds which he believed were comparable to the subject interest. He removed eight funds from the fifteen because they had guaranteed payouts. The remaining seven funds traded at an average discount of 14.8%. Ultimately, the expert concluded that an investor would demand a larger discount than the comparables because the corporation (1) had fewer assets than almost all comparables, (2) paid fewer dividends than the average of all comparables that paid dividends in amounts similar to those of non-guaranteed payout comparables, and (3) was outperformed on average by the comparables without guaranteed dividend payouts.

The government's expert applied a 5% discount for lack of control. As his starting point, he used an average discount of 8.61% for closed end funds that he obtained from an article in the *Journal of Economics*. The expert considered the subject entity a well managed holding company with a diversified portfolio of marketable securities. He opined that management decisions, which are more critical with respect to operating entities, were less relevant in this case and therefore a hypothetical buyer/investor in the stock would be less concerned about lack of control.

The court was critical of the taxpayer's expert's analysis of the closed end funds. The court was also unable to agree with the taxpayer's expert's assumption that the discounts reflect in the closed end funds he chose were due to lack of control, interestingly suggesting that part of the discount might be due to lack of marketability (even though such funds are freely traded).

Comparing factors such as size, performance, diversification, the passive nature of the investments, and the company's established long term performance of good returns, the court held that a 10% lack of control discount was appropriate.

The taxpayer's expert applied a 35% lack of marketability ("LOM") discount, relying primarily upon the restricted stock studies. The government's expert applied a 10% LOM discount, based upon his analysis of factors described in *Mandelbaum v. Comm'r*. Those factors include (1) financial statement analysis, (2) dividend policy, (3) outlook of the company, (4) management of the company, (5) control factor in the shares to be purchased, (6) company redemption policy, (7) restriction on transfer, (8) holding period of the stock, and (9) cost of the public offering. The government's expert began with the assumption that a 20% discount was the average discount and then applied the various *Mandelbaum* factors to arrive at a 10% discount. He believed the corporation's well-diversified portfolio resulted in a low price volatility and dictated a low LOM discount.

The court did not rely much on the expert testimony of either party in determining the LOM discount, but did adopt a *Mandelbaum*-type approach. In determining its 15% LOM discount, the court noted the following company specific factors favored a lower than average discount: (1) financial performance, (2) history of long term appreciation, (3) diversified portfolio, (4) quality management, and (5) lack of restrictions on the transferability of shares. The court also opined that holding period for the stock (i.e. the entity will not terminate in less than 20 years) and lack of redemption policy favor a higher than average discount. Thus, the court found that the factors outlined in *Mandelbaum* "favor a lower than average discount for lack of marketability" – although the court does not define its "average" lack of marketability discount benchmark.

H. *Kelly v. Comm'r.*

The decedent, his daughter and his son-in-law formed a partnership in a limited liability company, which owned a one percent general partnership interest in the partnership. At the time of his death, the decedent owned a 94.83% interest in the partnership and a 33.33% interest in the limited liability company. The decedent's daughter and son-in-law owned a remaining interest in the entities. The principal assets of the partnership were cash and certificates of deposit having a value of approximately $1.2 million. The estate's expert determined the fair market value of the decedent's partnership interest using net asset value and income approaches and applied a 53.5% valuation discount. The IRS's expert determined the value of the partnership interest using the net asset approach, and applied a 25.2% valuation discount.

The court applied the net asset value methodology to value the interest. The court noted that both experts calculated the minority interest discount by reference to general equity closed end funds. Accepting the figure calculated by the IRS's expert (having held that the estate's expert's sample study was too small), the court applied a 12% minority interest discount. The court also determined that a 23.5% lack of marketability discount was appropriate. The court thus applied a 32% discount when valuing the interest owned by the decedent.

I. *Temple v. United States.*

In *Temple*, Case No. 97 A.F.T.R. 2d 2006 1649 (U.S.T.C., ED. TX 2006), the District Court addressed the value of gifts of interests in four entities: a limited partnership that owned and operated a ranch in south Texas; a limited liability company that owned and operated a winery in California; a limited partnership that held stock in Temple Inland; and a limited partnership that held stock in Time Warner.

With respect to the ranch partnership, the court applied a 38% combined lack of control and lack of marketability discount. The court also rejected the taxpayer's request for an unrealized capital gains discount because of the potential for an I.R.C. § 754 election.

With respect to the LLC that operated the winery, the interest being valued was a 76.6% interest, which provided the donee with the power to cause the dissolution of the entity. Since California law did not mandate that the assets be sold upon a dissolution, the 76% owner could become a tenant-in-common with the other owners upon dissolution of the LLC. Because of zoning requirements, the property could only be divided into two tracts, and a partition would have been extremely difficult to accomplish. Thus, the court did not accept the IRS's denial of discounts for lack of control because the size of the interest allowed the donee to dissolve the partnership. The court applied a 60% discount, which was actually higher than the discount the taxpayer had used in submitting the gift tax returns.

With regard to the marketable securities partnerships, the court based the lack of control discount upon the closed end mutual fund data. The court also applied a 12.5% lack of marketability discount. The lack of control discounts range from 3.3% to 10.1%, depending upon when the gifts were made.

J. *Estate of Kohler v. Comm'r.*

In *Kohler*, T.C. Memo 2006-152 (July 25, 2006), the decedent died owning a minority interest in Kohler Co. Kohler Co. (the "Company") is a closely held entity, best known for its kitchen and bath products, which has been in existence for over a hundred years. The Company's stock is not publicly traded. It has a stated policy of paying 7% to 10% of its earnings in dividends to its shareholders.

In the Estate Tax Return filed for Mr. Kohler's Estate (the "Estate"), the value of the Kohler shares owned by decedent on the alternate valuation date was determined to be approximately $47 million. The Estate Tax Return was audited, and the IRS claimed that the shares had a fair market value of $144.5 million in its notice of deficiency. The IRS also asserted an almost $11 million accuracy related penalty.

The Estate and the IRS both submitted expert reports determining the valuing of the stock. The Estate relied upon two experts, the IRS, one. The experts determined a wide range of proposed valuations, ranging from $47 million (the Estate's first expert, whose report was submitted with the Estate Tax Return), $63 million (the Estate's second expert), and $156 million (the IRS's expert).

The court noted several significant concerns about the reliability of the IRS's expert's report. The court's concerns included the lack of customary certification of the report and the fact that his report was not prepared in accordance with all USPAP standards and the expert's initial erroneous overvaluation of the stock by $11 million. Most importantly, the court simply did not believe that the expert understood Kohler's business. The court noted that the expert spent only two and a half hours meeting with management. Given the limited exposure to the Company's management, the court was puzzled as to why the expert determined that the expense structure in the Company's projections was wrong and decided to invent his own for his income approach. The court also criticized the IRS's expert for failing to discuss the expense structure with management to test whether it was realistic, as well as his decision to weight the aspirational operations plan model at 80% in his income approach instead of the Company's more realistic management plan projections. Finally, the court expressed concern that the expert failed to use a dividend based method under the income approach given that the record reflected that periodic dividends were the primary means of obtaining a return of Kohler stock due to the privately held nature of the Company. Because of these concerns, the court gave no weight to the IRS's expert's conclusions.

The Estate's first expert determined the value of the stock based on both a DCF analysis and a dividend based approach (including both discounted dividend method and a dividend capitalization method). The expert applied the dividend approach because he believed that dividends represent the best, if not the only, opportunity for a minority shareholder to receive a cash return on his or her investment. The first expert applied a 45% lack of marketability discount to the values determined under the DCF approach and a 10% lack of marketability discount to the values determined under the dividend based methods. He determined the value of the shares to be approximately $47 million.

The second expert used the DCF approach with the discounted dividend method, and the adjusted discounted dividend method. He also used several publicly traded guideline companies and applied valuation multiples to those entities to estimate the value of each Kohler market segment. The expert then considered each of the values he had determined and found that they all resulted in values fairly close to each other. He ultimately determined that the adjusted discounted dividend method was the most appropriate method because it reflected the actual cash flow a shareholder could expect to receive. He then applied a 35% discount for lack of marketability based upon restricted stock studies and the stock of other companies. Applying various other minor adjustments, the second expert determined that the fair market value of the stock was approximately $63 million. As noted, the court found that these two valuations reflected the true nature of the Kohler business and used valuation methods considered reliable for privately held companies like Kohler. Having rejected the IRS's expert's opinion completely, the court determined that the IRS had failed to carry its burden of proof in the case and held that the value of the stock owned by the Estate on the alternate valuation date was approximately $47 million. The court also summarily rejected the IRS's accuracy related penalty.

V. DEFINED VALUE OR FORMULA TRANSFERS.

In an environment where the continued long-term existence of the federal estate tax has become uncertain, estate planners are discovering that clients are becoming hesitant to engage in transfer tax planning transactions that trigger a substantial gift tax. One of the techniques increasingly used by planners to attempt to cap gift tax exposure with respect to a gift or sale transaction involving a hard to value asset is a formula clause. These clauses are designed to limit the transferor's gift exposure by either adjusting the value of the interest transferred to the extent a different value is "finally determined for gift tax purposes" (a "value adjustment clause") or specifying the dollar value of the interest transferred (a "defined value clause").[10]

In the typical valuation case, the taxpayer simply argues that the value determined by the appraiser is correct. With a formula clause, the taxpayer possesses additional arguments to avoid the imposition of transfer tax.

A. Value Adjustment Clauses.

There are generally two types of value adjustment clauses. The first type of clause provides that if it is finally determined for transfer tax purposes that the value of the property transferred exceeds a specified dollar amount (*e.g.*, by agreement with the IRS or by a court decision), the size of the transferred interest is reduced so that the value of the property transferred equals the specified dollar amount. The second type of clause, rather than adjusting the size of the transferred interest, requires the transferor to give additional consideration to the transferor equal to the difference between the value of the interest as finally determined for transfer tax purposes and the specified dollar amount.

The IRS has taken the position that such clauses should be ignored for transfer tax purposes, asserting that the clauses are against public policy because they are a condition subsequent to the transaction that render any audit or litigation regarding value meaningless. The IRS claims that the clauses waste both the IRS's and the court's time, because once a determination is made that the value of the transferred property is higher than the taxpayer believed, the formula clause kicks in to adjust the transaction so that no gift tax is owed. Taxpayers assert that such clauses provide the taxpayer with certainty as to the tax they owe in a given transaction, and are designed with the very admirable goal of avoiding valuation disputes with the IRS. Over the years, several value adjustment clauses have been tested in the courts,

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[10] *See, e.g.*, Moore, *Attempting to Achieve Finality in Potentially "Open" Transactions*, U. OF MIAMI INST. ON EST. PLANNING 13 EST., GIFTS & TR. J. 83 (1988); Moore and Buchanan, *Valuation and Readjustment Clauses: What's Possible?*, 45TH NYU TAX INST. (1987); McCaffrey and Kalik, *Using Valuation Clauses to Avoid Gift Taxes*, 125 TRUSTS AND ESTATES 47 (Oct. 1986).

with the results generally favoring the IRS's position that the gift tax consequences of the transfer should be determined without regard to the clause.

The validity of value adjustment clauses was first addressed in *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944). In *Procter*, the taxpayer transferred property and provided in the transfer document that if it were determined by a final judgment of a court of last resort that any part of the transfer was subject to gift tax, the property subject to gift tax would be deemed excluded from the transfer and would remain the transferor's property. The Fourth Circuit Court of Appeals held that the provision did not eliminate the taxable gift because it imposed a condition subsequent that violated public policy. The court determined that the provision would be "trifling with the judicial process" (*id.* at 827) and would inhibit tax collection since attempts to enforce the tax would defeat the gift. Moreover, the court held that giving effect to the provision would obstruct justice because courts would have to pass on a tax issue that became moot once the decision was rendered.

In *Ward v. Comm'r*, 87 T.C. 78 (1986), the Tax Court held that a gift of shares of stock of a closely-held corporation which the donor reserved the right to revoke the gift to the extent the value of each share was "finally determined for federal gift tax purposes . . ." to exceed $2,000 would be disregarded for purposes of determining the amount of the gift. The Tax Court opined that the transaction was a gift subject to a power of revocation exercisable upon the occurrence of an event beyond the control of the donor. Because the donor had no control over the possible revocation of the gift, the court determined that the donor parted with all dominion and control over the transferred property and that there was a completed gift of the entire property. Moreover, the Tax Court also determined that the clause violated public policy under the analysis set forth in *Procter*. The Tax Court also ignored valuation adjustment clauses in *Harwood v. Comm'r*, 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (1986), and *Estate of McLendon v. Comm'r*, 66 T.C.M. (CCH) 946 (1993), *rev'd on other grounds*, 77 F.3d 477 (5th Cir. 1995).

Taxpayers, however, are not without a court victory upholding a value adjustment clause. In *King v. United States*, 545 F.2d 700 (10th Cir. 1976), the taxpayer sold stock to trusts for his children for $1.25 per share, a price the taxpayer believed to be equal to its then fair market value. The sales agreements provided that "if the fair market value . . . as of the date of . . . [the agreement] is ever determined by the Internal Revenue Service to be greater than the fair market value determined in the . . . manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service." 545 F.2d at 703-04. The IRS took the position that the shares were worth more than $1.25 per share, and that the price adjustment clause was ineffective. The Tenth Circuit rejected the IRS's argument, holding that the taxpayer had not made a taxable gift. The court distinguished the case from *Procter* since the sole purpose of the *Procter* clause was to rescind the transaction in the event it was determined to be a taxable gift. The *King* court stated that

> Here, there was at no time or in any way an attempt to alter or negate the plain terms of the valuation clause and no attempt by the trustees to reconvey the stock to King or to cancel the note in anticipation of an unfavorable valuation ruling. Authorities relied upon by the Government dealing with contingencies which, upon

> fruition, alter, change or destroy the nature of the transaction do not apply here. The proviso for adjustment of the purchase price of the stock to equal its fair market value did not effect the nature of the transaction.

Id. at 705. The Tenth Circuit found that the *King* clause had a proper purpose; that is, "an attempt to avoid valuation disputes with the Internal Revenue Service agents by removing incentive to pursue such questions is not contrary to public policy in the absence of a showing of abuse."

B. Value Definition Clauses.

Although value definition clauses have the same dispute avoidance goal as value adjustment clauses, they operate very differently. Rather than adjusting the value of a gift after an adverse determination, a value definition clause seeks to specify the value of the transferred interests at the time of the transfer. For example, if a transferor desires to give a $1 million interest in an entity to a child, the transfer document would specify that the transferor assigns to his child that number of shares having a fair market value of $1 million on the date of the gift. Until recently, the IRS has not focused on value definition clauses in the same manner that it focused on adjustment clauses. But in FSA 200122011, the IRS took the position that value definition clauses are also void against public policy under the same theories as set forth in *Procter*, *Ward*, and their progeny.

The application of *Procter* and *Ward* to value definition clauses is directly at issue in *McCord v. Comm'r*, 120 T.C. 358 (2003). In *McCord*, the taxpayers made a gift of their 82% limited partnership interests to a group consisting of their sons, generation-skipping trusts for the benefit of each son's family line, and two charities. The gift was made using a value definition clause in which the taxpayers specified that their sons and the trusts, collectively, had the right to receive that portion of the transferred interest having a fair market value of $6.9 million with the remainder of the interests passing to the charities. The taxpayers left it up to the donees to determine what portion of the 82% interest passed to the sons and the trusts (*i.e.* what portion of the interest had a fair market value of $6.9 million), and what portion passed to the charities. After the gift was made and after an appraisal was obtained, the donees entered into an arm's length agreement as to the percentage interest each received in a document entitled "Confirmation Agreement." The partnership redeemed the charities' interests approximately seven months after the gifts.

The IRS argued that the value of the partnership interests transferred by the McCords was substantially greater than that set forth in the gift tax return. Relying on *Procter*, the IRS also asserted that the defined value clause should be ignored. As to the value definition clause, the taxpayers countered that the clause should be respected, asserting that the gift tax is based upon the state law property rights transferred (*see United States v. Bess*, 357 U.S. 51 (1958)), and that the rights transferred to the sons and the trusts under the assignment agreement were the right to receive, collectively, interests in the partnership having a fair market value of $6.9 million. Thus, the value of the gift to the sons and the trusts was equal to $6.9 million.

The taxpayers also argued that clauses similar to the defined value clauses used to transfer the 82% interest are commonly used in other areas and have been approved by the IRS.

Using such clauses, a donor can define the amount of a transfer that is subject to tax and ensure that the remainder is either entitled to a deduction from such tax or is not subject to such tax. *See*, *e.g.*, Rev. Proc. 64-19, 1964-1 C.B. 682 (defined value formula for funding the marital deduction). *See also* Treas. Reg. 25.2518-3(c) (defined value formula for pecuniary disclaimer). Similarly, the treasury regulations specifically sanction using formula allocations of GST exemption to ensure that a generation-skipping transfer is exempt from GST tax or that a generation-skipping trust has an inclusion ratio of zero. *See* Treas. Reg. §§ 26.2632-1(b)(2), 26.2632-1(d)(1). Likewise, the regulations permit the use of formula clauses in determining the amount passing to charity under a charitable trust. Treas. Reg. § 1.664-2(a)(1)(iii) (percentage of initial fair market value as finally determined for federal tax purposes); Treas. Reg. § 1.664-3(a)(1)(iii) (adjustments in annuity amounts if incorrect determination of fair market value has been made). *See also* Rev. Rul. 72-392, 1972-2 C.B. 573, 344, modified by Rev. Rul. 80-123, 1980-1 C.B. 205; Rev. Rul. 82-128, 1982-2 C.B. 71. The IRS has even recognized the validity of a value definition clause in its pronouncements. T.A.M. 8611004 (Nov. 15, 1985).

The taxpayer also distinguished *Procter* and its progeny because the cases involved formula clauses that attempted to adjust the terms of a gift *after the gift was made*. In those cases, assets were purported to be transferred in such a way that, if it was determined by the IRS or the court that a portion of the transfer would be subject to gift tax, the transaction was adjusted after-the-fact such that those portions were no longer subject to gift tax. *See, e.g., Procter*, 142 F.2d at 827; *Ward*, 87 T.C. at 114. Contrasting the case with *Procter,* the value of the interests transferred under the *McCord* defined value clause to the sons and the trusts were readily determinable, and were not subject to change. The sons and the trusts were entitled, collectively, to the first $6.9 million of transferred interests. The value of the transfer to the sons and the trusts was unaffected by any determination by the court or by the IRS. The taxpayers were simply trying to determine and establish with certainty, through the use of a formula clause specifying the dollar value of the interest in the partnership passing to each donee, the amount of gift tax that would result from the transfers. The taxpayers argued that the property rights transferred by the taxpayers to the sons and the trusts -- the right to receive assignee interests in the partnership with a fair market value of $6.9 million -- were clearly set forth in the assignment agreement and should be given effect for purposes of calculating the taxpayers' gift tax. *See Morgan v. Comm'r*, 309 U.S. 78, 80-81 (1940).

As noted above, a formula clause will provide the taxpayer additional arguments against the IRS in a valuation dispute involving a hard-to-value asset. In *McCord*, the value definition clause provided the taxpayers with two arguments in addition to asserting that the appraisal value was correct: namely, that (i) the fair market value of the gift was fixed by the valuation adjustment clause; and (ii) since the best evidence of value is the price at which an interest in the entity would change hands between a buyer and a seller in an arm's-length transaction, the value agreed upon by the donee's when determining the interests each were entitled to receive is the best evidence of value. Of course, the taxpayers argued that the value determined by the taxpayers' appraiser was correct.

On May 14, 2003, the Tax Court issued its opinion in *McCord v. Comm'r*, 120 T.C. 358 (2003). The Tax Court rejected the IRS's claim that the charitable deduction should be limited by the amount that the charity received because either the substance over form doctrine, public policy considerations, or the integrated transaction doctrine. However, a majority of the Tax Court found that the charity received a specific partnership interest equal to 5.1208888%, which was the amount that the charities received collectively in the confirmation agreement signed between all of the donees (but not Mr. and Mrs. McCord) several months after the partnership interests were transferred.

The majority's decision interpreted the assignment agreement under Texas law. Specifically, the Court stated that

> Whenever the concept of "property" is relevant for Federal tax purposes, it is State law that defines the property interest to which Federal tax consequences attach. *E.g.*, *United States v. Craft*, 535 U.S. 274, 278-279 (2002) (Federal tax lien attaches to property held, under State law, as tenants by the entireties). Thus, in order to determine the Federal gift tax consequences that attach to petitioners' assignment of the gifted interest, we look to applicable State law to determine the extent of the rights transferred. Because petitioners transferred interests in a Texas limited partnership, Texas law governs our determination in that regard.
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> . . . In essence, petitioners [donors] contend that because (1) they transferred to CFT [the residual charity] a portion of the gifted interest corresponding to the excess of the fair market value of that interest over $7,044,933, and (2) we have determined the fair market value of the gifted interest to be $9,883,832, it follows from the maxim beginning this paragraph that they are entitled to a charitable contribution deduction in the amount of $2,838,899 for their gift to CFT. Because the assignment agreement does not equate the term "fair market value" with the term "fair market value as finally determined for Federal gift tax purposes," petitioners' [property law] argument must fail.
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> . . .
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> By way of the assignment agreement, petitioners transferred to CFT the right to a portion of the gifted interest. That portion was not expressed as a specific fraction of the gifted interest (*e.g.*, one-twentieth), nor did petitioners transfer to CFT a specific assignee interest in MIL (*e.g.*, a 3-percent assignee interest). Rather, CFT was to receive a fraction of the gifted interest to be determined pursuant to the formula clause contained in the assignment agreement. The formula clause provides that CFT is to receive that portion of the gifted interest having a fair market value equal to the excess of (1) the total fair market value of the gifted interest, over (2) $7,044,933. The formula clause is not self-effectuating, and the assignment agreement leaves to the

> assignees the task of (1) determining the fair market value of the gifted interest and (2) plugging that value into the formula clause to determine the fraction of the gifted interest passing to CFT.
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> . . .
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> . . . The assignment agreement provides a formula to determine not only CFT's fraction of the gifted interest but also the symphony's and the children's (including their trusts') fractions. Each of the assignees had the right to a fraction of the gifted interest based on the value of that interest as determined under Federal gift tax valuation principles. If the assignees did not agree on that value, then such value would be determined (again based on Federal gift tax principles) by an arbitrator pursuant to the binding arbitration procedure set forth in the partnership agreement. There is simply no provision in the assignment agreement that contemplates the allocation of the gifted interest among the assignees based on some fixed value that might not be determined for several years. Rather, the assignment agreement contemplates the allocation of the gifted interest based on the assignees' best estimation of that value. Moreover, each of the assignees' percentage interests was determined exactly as contemplated in the assignment agreement (without recourse to arbitration), and none can complain that they got any less or more than petitioners [donors] intended them to get. Had petitioners [donors] provided that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes, we might have reached a different result. However, that is not what the assignment agreement provides.
>
> Of course, the assignees' determination of the fair market value of the gifted interest, while binding among themselves for purposes of determining their respective assignee interests, has no bearing on our determination of the Federal gift tax value of the assignee interests so allocated. . .

120 T.C. at 370-98.

The majority thus concluded that the donor was entitled to a charitable deduction equal to $594,743. This amount was higher than the dollar figure the charities received when their interests were redeemed six months after the assignment.

Judges Laro and Vasquez dissented, finding that under the IRS's common law arguments they would have allowed a deduction for only the amount actually received by the charity in the redemption.

Judges Chiechi and Foley concurred in part and dissented in part. They rejected the majority's interpretation of the assignment agreement under Texas law. Both also found, in separate concurring opinions, that the assignment agreement should govern the property rights transferred to the donees and that under Texas property law, the value of the gift to the taxable donees was $6,910,933 -- the amount specified in the assignment agreement.

On August 22, 2006, the Fifth Circuit issued an opinion reversing the Tax Court's Majority opinion. See *Succession of Charles T. McCord, Jr., et al. v. Comm'r.*, 461 F.3d 614, (5th Cir. 2006). The Fifth Circuit emphasized that the fair market value of the interests transferred must be determined on the date of the gift. The Court noted that

> The Majority's key legal error was its confecting sua sponte its own methodology for determining the taxable or deductible values of each donee's gift valuing for tax purposes here. This core flaw in the Majority's inventive methodology was its violation of the long-prohibited practice of relying on post-gift events. Specifically, the Majority used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts into percentage interests in MIL. It is clear beyond cavil that the Majority should have stopped with the Assignment Agreement's plain wording. By not doing so, however, and instead continuing on to the post-gift Confirmation Agreement's intra-donee concurrence on the equivalency of dollars to percentage of interests in MIL, the Majority violated the firmly-established maxim that a gift is valued as of the date that it is complete; the flip side of that maxim is that subsequent occurrences are off limits.

Id. at pp. 9-10; *citing Ithaca Trust Co. v. United States*, 279 U.S. 151 (1929); *Estate of McMorris v. Commissioner*, 243 F.3d 1254 (10th Cir. 2001); *Estate of Smith v. Commissioner*, 198 F.3d 515, 522 (5th Cir. 1999). Thus, the Court focused on the values of the interests transferred by Mr. and Mrs. McCord as stated in the Assignment Agreement, and not the percentage interests reflected in the donee's Confirmation Agreement that was executed several months after the gifts.

The Court also reversed the Tax Court's opinion with respect to the present value of potential taxes under § 2035. The Fifth Circuit reasoned that "[t]here is nothing speculative about the date-of-gift fact that if either or both Taxpayers were to die within three years following the gift (as did Mr. McCord)," the non-charitable beneficiaries were obligated to pay the additional estate tax imposed under 2035. *Id.* at p. 11. The Court noted that while some contingent liabilities can be too remote to consider, the appropriate discount rate to be used to determine the gift tax liability is not a matter of speculation because "§ 7520 dictates precisely the rate of interest to be applied; and here, it is the rate that was applicable on the date of the gift." In sum, the Court concluded that a willing buyer would take into account the contingent liability for § 2035 estate taxes in determining the value to be paid for the transferred interests, and that the value of the interests for gift tax purposes should also take that contingent liability into account.

VI. VARIOUS VALUATION ADJUSTMENTS.

A. Minority Interest and Lack of Marketability.

Most individuals involved in the valuation process are familiar with the standard minority interest and lack of marketability adjustments which are applied when valuing partial interests in property. A minority interest discount reflects the fact that the shareholder or owner of a partial interest who owns less than a majority cannot control managerial decisions, impact future earnings, control efforts for growth, or establish executive compensation. A lack of marketability discount is influenced by the speed and efficiency with which an investor can buy and sell an investment. The value of an interest in a privately held company is not directly comparable to the value of a similar publicly traded interest because privately held companies and minority interests in those companies are not actively traded on a stock exchange as are shares of publicly traded companies. Therefore, the fair market value of an interest in a private company is adjusted to reflect its lack of liquidity and lack of a ready market. *Estate of Newhouse v. Comm'r*, 94 T.C. 193, 217 (1990).

Both the minority interest discount and the lack of marketability discount are factual determinations. Critical to this determination is an appreciation of "the fundamental elements of value that are used by the investor in making his or her investment decision." *Mandelbaum v. Comm'r*, 69 T.C.M. (CCH) 2852, 2864 (1995), *aff'd without opinion*, 91 F.3d 124 (1996).

In *Estate of Brown v. Comm'r* (Tax Court Docket Nos. 7492-95 and 14899-96), I asked the IRS to admit through discovery that certain factors the IRS utilized in a partnership valuation case (*Robertson v. Comm'r*, Tax Court Docket Nos. 26090-95, 26091-95, and 12782-96) were appropriate for determining the amount of a discount for minority interest and lack of marketability in determining the value of a limited partnership interest in another tax court valuation case. In *Robertson*, the IRS used a 70% combined discount for the minority interest and lack of marketability in valuing a limited partnership interest which was purchased by parents from one of their children. The primary asset of the partnership was non-income producing ranch land. Because the parents paid an amount equal to pro rata net asset value for the interest, the IRS claimed the parents had made a gift. The case settled shortly after trial for no deficiency, the IRS apparently deciding that it was not in its best interest to have a published decision in which it claimed that such a steep discount should be applied. However, in response to informal discovery in *Robertson*, the District Counsel of the IRS identified the following factors which should be considered in determining the fair market value of a minority interest in a partnership:

> The IRS admits that a discount of 70% was used in valuing the 6% limited partnership interest. The IRS believes that there are many considerations that enter into evaluation of a partnership interest. Those consideration (sic) include lack of lack of (sic) marketability and minority interest. The IRS also believes that in valuing interest in family limited partnerships, such as the 6% interest in [Robertson family partnership], considerations must be given to other additional factors, including, but not limited to:

> management risk, asset risk that arise due to concentration of asset in one class/or geographic region, limited cash distributions to partners, limited liquid assets for making distributions, expected returns, lack of an active organized secondary market for interest, restrictions on the transfer of interest by partners, concentration of control over the partnership, the economic outlook for the business or geographic area the partnership operates in, the partnership's position in the industry, the partnership's historical profitability, and expectation of future profitability, values of comparable interest traded on secondary markets and restrictions on transferability.

In *Brown*, I requested that the IRS admit that the considerations set forth above were proper factors for an appraiser to consider in determining the fair market value of the partnership interests owned by Mrs. Brown at the time of her death. The Service responded to my request as follows:

> Admits, but denies any implication that such a listing encompasses the universe of appropriate factors to consider.

B. Discounts Applied to Majority Ownership Interests.

Discounts can and do exist in the context of controlling interests. The existence of the discount for a controlling interest depends upon the facts and circumstances of each particular case. *See Estate of Trenchard v. Comm'r*, 69 T.C.M. (CCH) 2164 (1995) (discount applied to interest in a corporation in which decedent owned 60.92% of voting power); *Estate of Luton v. Comm'r*, 68 T.C.M. (CCH) 1044 (1994) (lack of marketability discount of 20% for stock of a corporation owned 78% by the decedent); *Estate of Bennett v. Comm'r*, 65 T.C.M. (CCH) 1816 (1993) (15% lack of marketability discount for real estate management company with varied, illiquid assets held in a corporate shell); *Estate of Dougherty v. Comm'r*, 59 T.C.M. (CCH) 772 (1990) (25% discount applied to a 100% interest in corporation that owned real estate, securities, fixed assets and other long term investments).

Various factors may be relevant in determining whether a valuation adjustment is applicable to controlling interest in a closely held entity. For example, a buy/sell agreement contained in the corporate charter may restrict the ability of a shareholder to transfer her interests, creating "a chilling effect on prospective investors." *Mandelbaum*, 69 T.C.M. (CCH) at 2866 (1995). Furthermore, the presence of environmental problems may impact marketability. *See Estate of Desmond v. Comm'r*, 77 T.C.M. 1529 (1999); *but see Estate of Pillsbury v. Comm'r*, 64 T.C.M. (CCH) 294 (1992).

A diverse asset mix of assets owned within the controlled entity may affect marketability (whether it is called a lack of marketability or portfolio discount), since the entire entity would not likely interest any one particular buyer. *See, e.g.*, *Estate of Bennett v. Comm'r*, 65 T.C.M. (CCH) 1816, 1826 (1993) ("We think some discounting is necessary to find a buyer willing to buy Fairlawn's package of desirable and less desirable properties."); *Estate of Dougherty*, 59 T.C.M. (CCH) at 780-81 (Court applied a 10% discount for incremental management costs and 25% discount for lack of marketability because the assets of the

Corporation were so varied, consisting of real estate and other non-liquid assets); *Estate of Luton v. Comm'r*, 68 T.C.M. (CCH) 1044 (1994) (decedent owned 78% of a passive real estate corporation, yet the court still allowed a 20% marketability discount); *Estate of Simpson v. Comm'r*, 67 T.C.M. (CCH) 2938 (1994) (decedent owned 100% of an investment holding corporation and the court allowed a 30% marketability discount).

Finally, the existence of the corporate shell itself may affect value (when the corporation is valued on a net asset basis), since purchasers as a general rule would prefer to purchase the corporation's assets directly rather than the stock. Such a direct purchase would avoid hidden corporate liabilities, tax issues involving the corporation, and the need to deal with the minority interest holders. *See, e.g.*, *Bennett*, 65 T.C.M. at 1825 ("The corporate form cannot simply be ignored as the IRS would have us do. The benefits and burdens of corporate form are often the very reasons upon which the decision to apply or to not apply a discount for lack of marketability is based."); *Gallun v. Comm'r*, 33 T.C.M. (CCH) 1316 (1974) ("[W]e believe that the IRS's witness erred in refusing to discount the value of the stock to account for a corporate entity intervening between the investment assets and the owner of Gallun stock.").

C. Unrealized Capital Gains.

In *Estate of Davis v. Comm'r*, 110 T.C. 530 (1998), the Tax Court recognized the real liability represented by the built-in capital gains tax associated with appreciated capital assets held in a C corporation for the first time since the repeal of the General Utilities doctrine. At issue in *Davis* was the gift tax value of two 25 share blocks of stock (of the total of 97 shares) of A.D.D. Investment & Cattle Company ("ADDIC") to each of two sons. ADDIC was a family owned holding company, the assets of which included over 1% of the issued and outstanding common stock of Winn-Dixie, listed on the New York Stock Exchange, and assets related to ADDIC's cattle operations. ADDIC assets had a total built-in capital gains tax liability of $26.7 million, about 96% of the gain being attributable to its Winn-Dixie stock. The Court allowed a $9 million adjustment for built-in capital gains tax, representing approximately 1/3 of the total capital gains tax liability on all of the corporate assets. The petitioner's two experts and the IRS's expert (but not the IRS) believe that an adjustment was warranted -- that is, a willing buyer and a willing seller would have taken the built-in tax liability into account in arriving at a purchase price for the stock. The dispute was over the amount of the adjustment. The Court found that the full amount of built-in tax liability could not be taken as a discount when there was no evidence that ADDIC planned to liquidate or sell its assets. The Court concluded that a $9 million discount was properly included as a part of the lack of marketability discount to be applied in value in the two blocks of stock.

Following quickly on the heels of the Davis decision was the Second Circuit's decision in *Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998), reversing a memorandum decision of the Tax Court. The Appeals Court found that the Tax Court erred in not considering the built-in capital gains tax as a liability and remanded the case back to the Tax Court to decide on the amount of the liability. This reversal is the last nail in the coffin of the notion that built-in capital gains taxes should not be considered in valuing C corporations. The IRS has acquiesced in Eisenberg "to the extent that it holds that there is no legal prohibition against such a discount." AOD 1999-001.

In *Estate of Jameson v. Comm'r*, 77 T.C.M. (CCH) 1383 (1999), the Tax Court again allowed a discount for unrealized capital gains. In *Jameson*, the decedent owned a 97% interest in a closely held corporation which had as its primary asset 5,405 acres of timberland in Louisiana. The fair market value of the timber property was $6 million. Its tax basis was approximately $200,000. Citing *Estate of Davis*, the Court allowed a built-in capital gains discount. In discussing this opinion, Judge Gayle stated

> We may allow the application of a built-in capital gains discount if we believe that a hypothetical buyer would have taken into account the tax consequences of built-in capital gains when arriving at the amount he would be willing to pay for decedent's Johnco stock. Because Johnco's timber assets are the principal source of the built in capital gains and, as discussed infra, are subject to special tax rules that make certain the recognition of the built in capital gains over time, we think it is clear that a hypothetical buyer would take into account some measure of Johnco's built in capital gains in valuing decedent's Johnco stock.

77 T.C.M. at 1396.

The Court concluded that since capital gains taxes would be incurred as Johnco's timber was cut and sold, recognition of the gain was certain to occur independently of any liquidation that a hypothetical willing buyer of decedent's Johnco stock "would take into account Johnco's built in capital gains, even if his plans were to hold the assets and cut the timber on a sustainable yield basis." However the court limited the discount "an amount reflecting the rate at which they [the capital gains taxes] will be recognized, measured as the net present value of the built in capital gains tax liability that will be incurred over time as timber is cut." *Id.*

The Fifth Circuit Court of Appeals reversed the Tax Court's decision. *Estate of Jameson v. Comm'r*, 267 F.3d 366 (5th Cir. 2001). The Court noted that the Tax Court had "deviated from several criteria of fair market value analysis, including assuming that a buyer was a strategic buyer who would continue to operate the corporation for timber production, peremptorily denying a full discount for the accrued capital gains liability based upon the erroneous assumption that the purchaser would engage in long range timber production." 267 F.3d at 371-72. The Court also noted that the Tax Court had internally inconsistent assumptions, assuming that a hypothetical purchaser of the stock would engage in long range timber production earning a 14% gross annual rate of return while requiring a 20% rate of return. Since the buyer would be earning less than his required rate of return, the buyer would either lower the purchase price or sell the interest quickly and re-deploy the proceeds elsewhere. The Fifth Circuit remanded the case back to the Tax Court for valuation analysis consistent with its opinion.

In *Estate of Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002) the Fifth Circuit applied a dollar-for-dollar discount for unrealized capital gains when determining the value of a 62.96% interest in a closely-held Texas corporation under an asset-based approach.

At her death, Mrs. Dunn owned 62.96% of Dunn Equipment was family-owned and operated company in the business of renting heavy equipment to refinery and petrochemical businesses. Reversing the Tax Court, the Fifth Circuit held, as a matter of law, the $7.1 million built-in capital gains tax liability of Dunn Equipment's assets must be considered as a dollar-for-dollar reduction when calculating the asset-based value of Dunn Equipment.[11] The Court opined that the very definition of the asset-based approach contemplates the consummation of the sale of the asset being valued, triggering the built-in capital gains tax. The holding makes rational sense, and should be applied in any asset-based valuation of a C corporation since the asset-based approach assumes that the buyer is paying for the stock of the entity based upon the price the buyer could realize for the assets of such entity. Before the buyer can realize such value, however, the corporate level capital gains tax must be incurred.

D. Blockage/Market Absorption.

The blockage discount applies to large blocks of property which cannot be placed on the market at the valuation date without depressing the price. The adjustment would apply to any large number of a particular type of asset being valued and which cannot be disposed of in a short period of time without depressing the market price. The discount has been applied to real estate, stock, and artwork. The basis for the discount was summarized in the Tax Court Memorandum decision in *Estate of Grootemaat v. Comm'r*, 38 T.C.M. (CCH) 198 (1979):

> Absorption is a price depressant caused by the disposition of the parcels of land in a short period of time creating competition among the parcels that might not otherwise exist. . .
>
> The record is clear that the 302 acres owned by GLC in November of 1971, if valued as a whole, would have a different value than if the values of the individual parcels were totaled. The disposition of all of the parcels of land owned by GLC within a reasonably short period of time would result in the different parcels (or their subdivisions) being in direct competition with each other. An abrupt increase in supply would, assuming demand remains constant, reduce the price for which these parcels or subdivisions would sell. This element of competition, a price depressant, is not taken into account in valuing the parcels individually. We therefore believe the discount for absorption is appropriate.

38 T.C.M. (CCH) at 203. *See also Carr v. Comm'r*, 49 T.C.M. (CCH) 507, 513 (1985) ("We agree with Petitioners that a discount [for market absorption] is necessary in order to reflect the absence of time within which to make an orderly disposition of the property"), and *Estate of Grootemaat v. Comm'r*, 38 T.C.M. (CCH) 198 (1979); Treas. Reg. § 20.2031-2(e).

The discount for market absorption is well recognized in the context of real estate. *Estate of Rodgers v. Comm'r*, 77 T.C.M. (CCH) 1831 (1999) ("In the case of real estate, the principles of supply and demand may warrant application of an absorption discount. That is because the disposition within a reasonable period of time of similar real properties would result in those being in direct competition with each other and other similar real properties in the

[1111] It did not apply the same reduction when determining value under the income-based approach.

marketplace."); *Estate of Folks v. Comm'r*, 43 T.C.M. (CCH) 427, 434 (1982) ("In simplistic terms, blockage refers to an immediate oversupply of goods which demand (the market) will not absorb at optimum prices. It is not unreasonable that placing 5 lumberyards on the market simultaneously in a limited geographical area would depress prices 20 percent"); *Brocato v. Comm'r*, 78 T.C.M. (CCH) 1243 (1999) (20% fractional interest and 11% blockage discount applied in valuing undivided interest in apartment projects).

A discount for blockage has long been recognized in the valuation of publicly traded securities. *See DuPont v. Comm'r*, 2 T.C. 246, 253, 257 (1943) (finding that blockage discount of approximately 12% applied for block of 52,900 shares of stock representing 8.48% in the company where average trading volume was 2,323 shares for the month before the valuation date); *Adair v. Comm'r*, 54 T.C.M. (CCH) 705, 711 (1987) (finding that increasing the market trading by 20% over a six-month period "would certainly have some effect upon the market").

E. Undivided Interests in Real Estate.

The IRS has often asserted that the only discount which should be applied when determining the fair market value of undivided interests in real property are the costs and expenses associated with a partition of that property. *See* PLR 9336002 (May 28, 1993). The Tax Court has consistently recognized, however, that IRS reliance on partition costs as the sole basis for the discount is misplaced.

In *Estate of van Loben Sels v. Comm'r*, 52 T.C.M. (CCH) 731 (1986), the Tax Court addressed the question of whether a fractional interest discount should be applied in valuing the decedent's undivided interests in 79,755 acres of timberland in California. The IRS contended that no discount was warranted. *Id*. at 740. Rejecting the IRS's contention, the Court held that "a discount from the value determined by reference to the fee value is warranted because of the disabilities associated with decedent's undivided interest. The disabilities include lack of marketability, lack of management, lack of general control, lack of liquidity, and potential partitionment expenses." *Id*. at 742. The Court held that because of the disability associated with owning an undivided interest in the properties, "a minority discount of 60% is reasonable in this case." *Id*. at 743. *See also Estate of Forbes v. Comm'r*, 81 T.C.M. (CCH) 1399 (2001) (30% discount allowed for undivided 42% interest in 5,354 acres of real property); *Williams v. Comm'r*, 75 T.C.M. (CCH) 1758 (1998) (44% discount for undivided interest applied to a one-half undivided interest in approximately 4,600 acres of timber property in Florida); *LeFrak v. Comm'r*, 66 T.C.M. (CCH) 1297, 1308-10 (1993) (holding that a 20% minority interest and 10% lack of marketability discount applied for undivided interest in New York apartment and office buildings).

In *Estate of Baird v. Comm'r*, 82 T.C.M. (CCH) 666 (2001), the Tax Court applied a 60% discount in valuing undivided interests in 16 non-contiguous tracts of Louisiana timber property. In Mr. Baird's estate tax return, the estate claimed a 25% fractional interest discount. The return was later amended to assert a 50% undivided interest discount. Mrs. Baird's estate tax return included a 50% undivided interest discount, and was later amended to assert a 60% discount. At trial, both estates claimed discounts of 60%. One expert of the taxpayer based his discount upon comparable sales and concluded that a discount of "at least 50% was appropriate." The second expert also relied on comparable sales and concluded that a

55% discount was appropriate. The third expert, James Steel of Monroe, Louisiana, made a living through buying and selling fractional interests. His report asserted that the discount should be at least 55%. At trial, he opined that the subject interest should be discounted by 90%. The Tax Court opined that a 60% discount was appropriate. The Tax Court primarily relied upon Mr. Steel's "personal knowledge and experience in the marketplace under consideration." 82 T.C.M. at 673.

F. **Control Premium**.

The rationale for a control premium is that a controlling shareholder has the power to elect the board of directors, influence corporate policy and directly affect corporate decision-making. The controlling shareholder may be able to unilaterally direct corporate action, decide the amount of distribution, rearrange the corporation's capital structure, and decide whether to liquidate, merge or sell assets. *Estate of Newhouse v. Comm'r*, 94 T.C. (CCH) 193, 217 (1990). For these reasons, a control premium is usually warranted in evaluating controlling interests.

In *Estate of Salsbury v. Comm'r*, 34 T.C.M. (CCH) 1441 (1975), the court identified the following powers that an owner has in a controlling stock interest: (1) the owner could elect the entire board of directors; and (2) the owner could, through the power to control the board, control the business and affairs of the corporation, elect and remove all of the officers, fix their salaries and control the declaration of dividends. Accordingly, the Court applied a 38.1% control premium to the value of the decedent's shares which constituted a 51.8% voting interest.

The Ninth Circuit Court of Appeals recently reversed the Tax Court's decision in *Estate of Simplot v. Comm'r*. In *Estate of Simplot v. Comm'r*, 112 T.C. 130 (1999), the Tax Court applied a control premium to the valuation of Class A voting stock in J.R. Simplot Co., a closely held corporation. At the time of the decedent's death, he owned 23% of the outstanding shares of voting stock and approximately 2.8% of the non-voting stock. The ratio of voting shares to non-voting shares was 1 to 1,848. The Tax Court applied a control premium equal to 3% of Simplot's equity value to the transferred voting shares on the theory that "one day (but not on the valuation date) the voting characteristics associated with them could have "swing vote" potential if the hypothetical buyer combined his 18 Class A voting shares with other family members' "shares" to form a control group." 112 T.C. at 179.

The Ninth Circuit Court of Appeals reversed the Tax Court's decision on the grounds that the Tax Court's swing vote theory erroneously applied the willing buyer, willing seller test. *Estate of Simplot v. Comm'r*, 249 F.3d 1191 (9th Cir. 2001). The Ninth Circuit determined that "the facts applied by the Tax Court were imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with Simplot children or grandchildren and what improvements in management of a highly successful an outside purchaser might suggest. 'All of these factors,' *i.e.*, all of these imagined facts, are what the Tax Court based its 3% premium upon. In violation of the law the Tax Court constructed particular possible purchasers." *Id.* at 1195. The Ninth Circuit also found that the Tax Court erred by (1) proportionately applying a control premium to the estate's minority interest in voting stock based upon a premium applied to all of the voting stock, and (2) failing to show that a purchaser of the voting stock would be able to use control to an increased economic advantage. The Court stated "in Richard Simplot's hands at the time of transfer his stock was worth what a willing buyer would have paid for the economic benefits presently attached to the stock. By this standard, a minority holding Class A share was worth no more than a Class B share."

G. Tax Affecting S Corporation Earnings.

In *Gross v. Comm'r*, 272 F.3d 333 (6th Cir. 2001), the Sixth Circuit Court of Appeals affirmed the Tax Court's valuation a minority interest in the stock of a Pepsi Cola bottling company, an S corporation, which made substantial distributions to its shareholders. In determining the fair market value of the transferred shares, the Tax Court agreed with the IRS expert's opinion that no tax should be imputed on the earnings of the S corporation under the discounted cash flow method applied by the expert. The Tax Court also applied the 25% discount for lack of marketability determined by the IRS's expert.

The Sixth Circuit Court of Appeals, in a 2-1 decision, affirmed the Tax Court's opinion. The majority held that the Tax Court did not commit clear error when it valued the stock in a manner consistent with the opinion of the IRS expert. The Court opined that the Tax Court weighed the testimony of the two competing experts and did not clearly err in accepting one expert's opinion over the other. The majority determined that tax affecting the stream of income under the facts of the *Gross* case was not required because of the disagreement among professional appraisers as to the propriety of employing such a procedure. The Court also opined that the Tax Court's refusal to tax affect the stock was not unfair to the donors, because (1) the donors were not justified in relying on internal IRS policy manuals concerning S corporation stock valuation; (2) there was no evidence that the corporation would lose its sub-chapter S status; and (3) the IRS was not precluded from taking the approach it did even if tax affecting had been used in previously approved returns.

The dissent believed that it was error not to tax affect the corporation's stream of income in determining the fair market value. The dissent focused on the fact that the IRS's appraiser did not know whether or not (1) real buyers and sellers, and (2) appraisers tax affected S corporation earnings in 1992 (the year in which the transfer occurred). The dissent also found persuasive the IRS's pronouncements regarding tax affecting of S corporation earnings and the treatment of prior gifts made by the donor.

In *Estate of Adams v. Comm'r*, 83 T.C.M. (CCH) 1421 (2002), the Tax Court did not allow of the income stream computed under a discounted cash flow approach to be adjusted for imputed income taxes on the S corporation's income when determining the fair market value of a 61.59% interest in a closely-held insurance agency. The Tax Court stated that "we disagree that [the taxpayer's expert's] estimates of WSA's prospective net cash flows are before corporate tax because it is appropriate to use a zero corporate tax rate to estimate net cash flows when the stock being valued is stock of an S corporation." 83 T.C.M. at 1425.

H. Tiered Discounts.

The IRS often takes the position that successive or tiered discounts should not be applied in determining the value of an interest in an entity which in turns owns an interest in another entity. But both the Tax Court and other courts have recognized the existence of "tiered discounts" when valuing an interest in a closely held entity. *See*, *e.g.*, *Gow v. Comm'r*, 79 T.C.M. (CCH) 1680 (2000) (the court applied combined discounts for lack of control and lack of marketability in valuing the stock of the top tier entity for 1989 and 1990, respectively, of 44% and 51%, and 41% in valuing the interest in the second tier entity); *Kosman v. Comm'r*, 71 T.C.M. (CCH) 2356 (1996); *Dean v. Comm'r*, 19 T.C.M. (CCH) 281 (1960); *Whittemore v. Fitzpatrick*, 127 F. Supp. 710 (D. Conn. 1954).

VII. PRIVILEGES IN THE ESTATE PLANNING CONTEXT

Because of the recent IRS attacks on family limited partnerships and limited liability companies, IRS requests for documents at the audit level and in estate tax litigation increasingly include requests for communications with counsel and other persons involved in the estate planning process seeking to determine the motives for creating the entity. This is particularly true in the area of buy-sell agreements, family limited partnerships, and closely-held corporations, where the IRS has become more aggressive in seeking to have entities ignored for estate tax purposes on the grounds that the entity lacks "business purpose" or was created solely as a "device" to avoid estate taxes. Attached as Exhibit 1 is an example of the type of IRS document requests that have been served on taxpayers over the last several years in audits involving closely held entities. The requests are extremely intrusive and cover every aspect of the estate planning and entity administration process.

A. Preparation for the Transfer Tax Audit or Dispute Begins at the Estate Planning Level – Anticipate Your Potential Audience.

The typical knee-jerk reaction to a request for documents or correspondence (particularly documents in a lawyer's file) is to assert all applicable privileges and refuse to produce the documents. However, the attorney-client privilege and the attorney work product privilege may not protect all contents in your file. More importantly, the production of carefully drafted estate planning correspondence or similar documents in response to such a request can actually help you state your case with the examiner or in litigation. With that goal in mind, as you are working on a client's estate plan, assume that every document prepared by the estate planning lawyer, the client, the accountant, or any other person involved in the estate planning process may be reviewed by an IRS agent, appeals officer, district counsel, or ultimate finder of fact in tax litigation.

Preparation for the transfer tax audit or dispute truly begins at the estate planning level. When writing letters or internal memoranda, think about how that document will look to an IRS agent, an appeals officer, or the ultimate finder of fact in tax litigation. Have you focused on all relevant reasons for the transaction or just the estate and gift tax savings that might be achieved through the transaction? Advise your client and the client's advisors, such as accountants or stockbrokers who are involved in the estate planning process, that their correspondence and their files may also be subject to production in a tax audit or in litigation.

B. Understand the IRS's Broad Subpoena Power.

The IRS has broad subpoena powers that can be used to subpoena documents or compel testimony from a taxpayer, the taxpayer's representative, or a third party. For the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax," the IRS is authorized (i) to examine any books, papers, records, or other data that may be relevant or material to such inquiry and (ii) to summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the IRS may deem proper to produce such books, papers, records, or other data. I.R.C. § 7602(a).

Subject to any applicable privileges, the IRS can summon the taxpayer, the taxpayer's attorney, the taxpayer's accountants, and other third parties to produce books, papers, records, or other data and to testify on matters relevant or material to the IRS's inquiry. This summons power includes lawyers, accountants, and others involved in the planning process. It also includes doctors or other health care providers. The range of discoverable documents is also very broad and generally includes all documents in any form (including, for example, computer files and emails).

To enforce a summons, the IRS must show that the summons: (1) was issued for a legitimate purpose; (2) seeks information relevant to that purpose; (3) seeks information that is not already within the IRS' possession; and (4) satisfies all administrative steps required by the United States Code. *United States v. Powell*, 379 U.S. 48, 57-58 (1964). However, the IRS's broad summons power remains subject to traditional privileges and limitations. *United States v. Euge*, 444 U.S. 707, 714 (1980). Thus, if the attorney-client privilege attaches to documents requested by the IRS, the IRS has no right to issue a summons to compel their production.

C. Understand and Preserve All Privileges.

As noted above, the IRS's subpoena power is limited to nonprivileged material. Whether or not a privilege exists in the context of an IRS examination is a question of federal law. *Jaffe v. Redmond*, 518 U.S. 1 (1996); Fed. R. Evid. 501. There are three types of privileges that may apply to a lawyer's file and correspondence: (i) the attorney-client privilege; (ii) the attorney work product privilege; and (iii) the tax practitioner's privilege. With respect to medical records, the doctor/patient privilege and psychotherapist/patient privilege may also come into play. None of the privileges is as broad as most lawyers believe.

1. The Attorney-Client Privilege.

a. What the Privilege Covers.

The attorney-client privilege generally protects the disclosure of confidential communications between counsel and the client made for the purpose of facilitating the rendition of legal advice. The attorney-client privilege also protects "an attorney's advice in response to such disclosures." *In Re Grand Jury Investigation*, 974 F.2d 1068, 1070 (9th Cir. 1992). In addition, "[t]he attorney-client privilege applies to communications between lawyers and their clients when the lawyers act in a counseling and planning role, as well as when lawyers represent their clients in litigation." *United States v. Chen*, 99 F.3d 1495, 1501 (9th Cir. 1996). Communications with third parties, such as accountants or financial advisors, that are made to "assist the attorney in rendering advice to the client" are also generally protected. *See United*

States. v. Adlman, 68 F.3d 1495, 1499 (2d Cir. 1995). ("[T]he privilege would extend to . . . an accountant hired by the attorney to assist the attorney in understanding the client's financial information.")

A privileged communication is "any expression through which a privileged person . . . undertakes to convey information to another privileged person and any document or other record revealing such an expression." *See, e.g.*, Restatement of the Law Governing Lawyers § 119 (Proposed Final Draft No. 1 1996). Documents protected by the privilege include those that consist of or reflect communications between the lawyer and the client, as well as the advice given to the client. Likewise, internal memoranda between attorneys in the same office representing the same client are covered by the attorney-client privilege. *Cedrone v. Unity Sav. Ass'n*, 103 F.R.D. 423, 429 (E.D. Pa. 1984) ("[I]t is inconceivable that an internal memorandum between attorneys in the same office concerning the representation of a client, utilizing confidential information provided by that client, could be anything but protected by the privilege."); *New York Underwriters Ins. Co. v. Union Constr. Co.*, 285 F. Supp. 868, 869 (D. Kan. 1968) (holding that interoffice memorandum between lawyers and communications and consultations between attorneys representing same party were covered by attorney-client privilege). Even an attorney's billing records, expense reports, and travel records that reveal particular areas of research or that reveal the nature of the services provided are protected under the privilege. *In Re: Grand Jury Witness*, 695 F.2d 359, 362 (9th Cir. 1982) (holding that bills, ledgers, statements, time records, and the like that reveal "the nature of the services provided" should be privileged).

Courts generally define "client" broadly, even extending the privilege to include prospective clients who reasonably believe that they are seeking legal advice. The Supreme Court has also extended the privilege to all corporate employees of a represented taxpayer if the communications at issue were made by corporate employees to counsel for the corporation acting as such, at the direction of corporate superiors in order to secure legal advice from counsel and the "employees . . . were . . . aware that they were being questioned in order that the corporation could obtain legal advice." *Upjohn Co. v. United States*, 449 U.S. 383, 394 (1981).

The attorney-client privilege survives the death of the client. *Swidler & Berlin and James Hamilton v. United States*, 524 U.S. 399 (1998).

b. What the Privilege Does Not Cover.

Communications with nonclients such as stock brokers, accountants, or other third parties that are *not* made to "assist the attorney in rendering advice to the client" are generally not privileged. *Adlman*, 68 F.3d at 1499. "What is vital to the privilege is that the communication be made *in confidence* for the purpose of obtaining *legal* advice *from the lawyer*. If what is sought is not legal advice but only accounting service . . . or the advice sought is the accountant's rather than the lawyer's, no privilege exists." *Id*. at 1499-1500, *citing United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961).

Work papers of the attorney that do not constitute or contain communications from the client, drafts of documents, and correspondence with third parties do not fall within the attorney-client privilege. *See Hickman v. Taylor*, 329 U.S. 495, 508 (1947) (holding that the privilege did not attach to "memoranda, briefs, communications and other writings prepared by counsel for his own use in prosecuting his client's case; and it is equally unrelated to writings which reflect an attorney's mental impressions, conclusions, opinions or legal theories").

In addition, advice rendered in connection with tax return preparation has been held not to be privileged. *See United States v. Frederick*, 182 F.3d 496, 500 (1999). The *Frederick* Court's refusal to apply the attorney-client privilege in the context of return preparation is based on the theory that return preparation is "accountant's work," whether performed by an accountant or a lawyer. For lawyers who prepare tax returns for clients, *Frederick* is a must read case.

In *Frederick*, an attorney/accountant claimed the attorney-client privilege for work papers prepared in the process of preparing tax returns for his individual clients and their closely held corporations. The Court held that the lawyer's "legal cogitations born out of his legal representation" that appeared in the work sheets for the preparation of the tax return would not be privileged, because of their use in tax return preparation. *Id.* at 501. Under the Seventh Circuit's analysis, disclosures made by a client during tax planning might lose their privileged status if incorporated in any way in work papers leading to the preparation of a tax return by the same representative.

The situation in *Frederick* was particularly complex because the attorney knew that the IRS was investigating the taxpayers and their company with regard to other tax years, and the attorney was representing the taxpayers' interests in connection with the investigation as well as preparing their current tax returns. *Id.* at 501. The tax return work papers could contain privileged information related to the years under investigation and could have dual purposes – litigation preparation and return preparation. The Court held that the "dual purpose" documents prepared for both tax return preparation and litigation were not privileged because of their relationship to the tax return.

In addition, the Court dealt with the question of whether documents prepared in connection with a tax audit are privileged. The Court viewed the audit as "both a stage in the determination of tax liability, often leading to the submission of revised tax returns, and a possible antechamber to litigation." *Id.* at 502. In its original opinion, the Court treated all audit representation the same way – as not qualifying for the privilege. However, the Court amended its opinion to provide that if the audit primarily concerns "verifying the accuracy of a return," then the audit representation is "accountant's work" whether done by an accountant or a lawyer. If the taxpayer's lawyer attends the audit "to deal with issues of statutory interpretation or case law that the revenue agent may have raised" in the audit, then the "lawyer is doing lawyer's work and the attorney-client privilege may attach." *Id.*

If the client retains an accountant to deal with verification and an attorney to do the "lawyer's work," then separating privileged communications from unprivileged communications during the audit is easy. Such separate representation is rarely practical. Any tax practitioner or court trying to separate privileged communications from unprivileged ones in a tax audit may face a very difficult process of sorting matters out after *Frederick*.

c. **Waiver**.

Beware: even if a document is privileged, that privilege can be waived. Disclosing otherwise privileged communications between a lawyer and client to third parties may cause those communications to lose their privileged status. *See, e.g., United States v. Brown*, 478 F.2d 1038 (7th Cir. 1973).

Moreover, under the doctrine of subject matter waiver, other communications related to the disclosed materials may lose their privileged status. Note that communications with accountants or other advisors, when made "to assist the attorney in rendering advice to the client," are protected under the attorney-client privilege. *See, e.g.*, *Adlman*, 68 F.3d at 1499; *Kovel*, 296 F.2d at 921-24 (holding that privilege may be properly invoked by accountant if communications were made pursuant to consultative role to attorney and at attorney's direction); *United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989) ("Information provided to an accountant by a client at the behest of his attorney for the purposes of interpretation and analysis is privileged to the extent that it is imparted in connection with the legal representation."); *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003) (providing short form opinion did not constitute waiver of attorney work product privilege); *In re G-I Holdings Inc.*, 218 F.R.D. 428 (D. N.J. 2003) (privilege deemed waived by asserting reasonable cause defense on the basis of legal advice). As with other communications sought to be protected by the privilege, to invoke the privilege, the client must establish that the communication with the third party was made "in confidence for the purpose of obtaining legal advice." *United States v. Gurtner*, 474 F.2d 297, 298 (9th Cir, 1973).

In a dispute we handled several years ago over whether the Service's summonses were enforceable in light of privilege issues, we argued that a holding of waiver in the context of communications to and from the client's financial advisors – where the communications were necessary for the purpose of rendering legal advice to the client in forming a business entity – would be contrary to the logic of the principle of the attorney-client privilege. *Segerstrom v. U.S.*, 87 A.F.T.R.2d 2001-1702, 2001 WL 263449 (N.D. Cal. 2001). The Court granted the taxpayer's request to quash the IRS's summonses, given the facts - disclosure to third parties was shown to be necessary for the lawyer to render legal advice to the client.

Olender v. United States, 210 F.2d 795 (9th Cir. 1954), would appear to stand for the contrary proposition. However, such a conclusion ignores the factual setting of *Olender*, where the Court found that the only purpose for which the attorney in question there was hired was to prepare net worth statements and tax returns. *Id.* at 806. In the transaction planning context, "[t]he attorney-client privilege applies to communications between lawyers and their clients when the lawyers act in a counseling and planning role, as well as when the lawyers represent their clients in litigation." *United States v. Chen*, 99 F.3d 1495, 1501 (9th Cir. 1996). According to the Ninth Circuit, "[c]alling the lawyer's advice 'legal' or 'business' advice does not help in reaching a conclusion [as to whether the communication is protected by the attorney-client privilege] . . . What matters is whether the lawyer was employed with or without 'reference to his knowledge and discretion in the law' to give the advice." *Id.* at 1502.

2. The Attorney Work Product Privilege.

Many lawyers believe that the attorney work product privilege absolutely protects their file from disclosure to third parties. The work product privilege is actually much narrower; it only shields from disclosure materials prepared "in anticipation of litigation" by a party or the party's representative, absent a showing of substantial need. Fed. R. Civ. P. 26(b)(3). The purpose of the doctrine is to establish a zone of privacy for strategic litigation planning and to prevent one party from piggybacking on the adversary's preparation. *See United States v. Nobles*, 422 U.S. 225, 238 (1975).

There is no bright line test to determine whether a document has been prepared "in anticipation of litigation." In the transaction planning process, however, it will be difficult to argue that an attorney's internal memos or work papers were prepared "in anticipation of subsequent litigation" with the IRS. *See United States v. Adlman*, 96-2 U.S.T.C. ¶ 50,493 (S.D.N.Y. 1996) (refusing to apply the work product privilege to an accountant's memorandum analyzing the "legal ramification of a proposed transaction to determine whether, despite a likely challenge, the legal risk was acceptable," and holding that "[t]he primary purpose of these documents was not to prepare for litigation; the primary purpose was to decide whether or not to go through with a multi-million dollar transaction"), *aff'd in part and rev'd in part*, 68 F.3d 1495 (2d Cir. 1995) (nothing that there is no bar to "application of work product protection to documents created prior to the event giving rise to litigation"), *supp. proceeding*, 134 F.3d 1194 (2d Cir. 1998) ("a document created because of anticipated litigation, which tends to reveal mental impressions, conclusions, opinions or theories concerning the litigation, does not lose work-product protection merely because it is intended to assist in the making of a business decision influenced by the likely outcome of the anticipated litigation. Where a document was created because of anticipated litigation, and would not have been prepared in substantially similar form but for the prospect of that litigation").

One court has even held that the power of the IRS to investigate the records of taxpayers makes doubtful the relevancy of the work product privilege enunciated in *Hickman* to a proceeding for the enforcement of an IRS summons. *United States v. McKay*, 372 F.2d 174, 176 (5th Cir. 1967) (reasoning that the IRS summons power is broad because all facts are in the taxpayer's hands).

The recent decision by the district court in Maryland, though, shows the continuing applicability of the work product doctrine. The court held that documents were not subject to the Section 7525 privilege but were protected under the work product privilege. *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003).

3. The Tax Practitioner's Privilege.

In the Internal Revenue Restructuring Act of 1998, Congress added I.R.C. § 7525, which extends the attorney-client privilege to confidential communications between taxpayers and practitioners that would protect the same "communication[s] between a taxpayer and an attorney." The privilege, however, is limited to (1) "non-criminal tax matters before the Internal Revenue Service" and (2) "non-criminal tax proceedings in Federal court brought by or against the United States." I.R.C. § 7525. Because the work product doctrine is separate from the attorney-client privilege, the new privilege provision does not grant the work product privilege to non-attorney advisors.

Frederick was the first case to address the tax practitioner privilege. The *Frederick* court took I.R.C. § 7525 into account in reaching its decision in concluding that, because the audit services rendered by the lawyer would not have qualified for the attorney-client privilege before enactment of the new privilege, the new privilege would not apply to the audit services rendered. *Frederick*, 182 F.3d at 502. Therefore, any information included in the documents involved in preparation of a tax return or involved in verification of a tax return during audit may lose either the attorney-client privilege or the new tax practitioner's privilege.

The First Circuit recently reinforced the *Frederick* court's construction of I.R.C. § 7525 in *Cavallaro v. United States*, 284 F.3d 236 (1st Cir. 2002). In *Cavallaro*, the First Circuit upheld the granting of enforcement of summonses issued by the IRS given that information was disclosed to accountants in a merger deal, and the accountants were providing accounting services, not facilitating communication of legal advice. The First Circuit reasoned that an attorney does not render client communications to an accountant privileged merely by engaging the accountant.

The district court for the District of Columbia has also issued several important decisions in the tax shelter litigation involving KPMG. In *United States v. KPMG*¸ 237 F. Supp. 2d 35 (D. D.C. 2002), citing *Frederick*, the court determined that the Section 7525 privilege did not extend to KMPG opinion letters issued to its client because such letters were prepared in connection of preparing a tax return. In a subsequent decision, the court determined that some of the documents KPMG claimed to be protected by Section 7525 were in fact so protected. *United States v. KPMG*, 2003-2 USTC ¶50,691 (D. D.C. 2003). *See also United States v. BDO Siedman, LLP*¸ 225 F. Supp. 2d 918 (N.D. Il. 2003), *aff'd*, 337 F.3d 802 (7th Cir. 2003) (name of clients not privileged under Section 7525); *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003) (accounting firm's advice not privileged because such accounting firm's communications with company were not delivered to facilitate communications between company and its attorney).

4. **The Physician-Patient Privilege**.

IRS requests for information increasingly seek access to medical records of a decedent and interviews with treating physicians. Under state law, a doctor-patient privilege often protects such information. However, where the IRS is seeking to enforce a summons issued under federal statutory authority, federal privilege rules generally apply. *See, e.g., United States v. Moore*, 970 F.2d 48, 50 (5th Cir. 1992).[12] The Fifth Circuit has held that there is no physician-patient privilege under federal law. *Id.* No other circuit has adopted the privilege. The Supreme Court has not yet directly addressed the issue.

[12] When Congress adopted the final version of the new Federal Rules Evidence in 1975, it rejected the nine enunciated privileges in the proposed rules (which included a physician-patient privilege) in favor of a single rule authorizing federal courts to apply "common law principles – in the light of reason and experience" in determining whether a privilege exists under the common law. The Senate Report accompanying the adoption of the Rules indicates that Rule 501 "should be understood as reflecting the view that the recognition of a privilege based on a confidential relationship . . . should be determined as a case by case basis." S. Rep. No. 93-1277, p. 13 (1974).

However, in *Jaffee v. Redmond*, 518 U.S. 1 (1996), the Supreme Court addressed the question of whether federal courts should recognize a psychotherapist-patient privilege under Rule 501. In *Jaffee*, the Supreme Court held that confidential communications between a licensed psychotherapist and a patient in the course of diagnosis or treatment are protected from compelled disclosure under Rule 501. In reaching its holding, the Court noted that:

> Like the spousal and attorney-client privileges, the psychotherapist-patient privilege is "rooted in the imperative need for confidence and trust." *Trammel*, 445 U.S. at 51, 63 L. Ed. 2nd 186, 100 S.C. 906. Treatment by a physician for physical illness can often proceed successfully on basis of a physical examination, objective information supplied by the patient, and the results of diagnostic tests. Effective psychotherapy, by contrast, depends upon an atmosphere of confidence and trust in which the patient is willing to make a frank and complete disclosure of facts, emotions, memories and fears. Because of the sensitive nature of the problems for which individuals consult psychotherapists, disclosure of confidential communications made during counseling sessions may cause embarrassment or disgrace.

Id. at 10. While the *Jaffee* Court did not rule on the applicability of a physician-patient privilege, the cited language shows that medical records based primarily upon physical examination and other objective information supplied by the patient or that result from diagnostic tests may not be considered privileged.

5. Privileges in the Appraisal Process.

a. The Attorney Should Hire the Appraiser.

In the transfer tax area, valuation appraisals often serve as the basis for a taxpayer's position with respect to the value of transferred property. Working with appraisers is an everyday event for most transaction planning attorneys. On the other hand, working with appraisers can be something of a rarity for most clients, many of whom have dealt with appraisers only in the purchase of their home. In addition, many clients do not enjoy working with appraisers. Although they are necessary, they are also expensive and can slow transactions down.

In most cases, the attorney, not the client, should hire the appraiser for a planning transaction. The attorney can offer guidance both to the client and the appraiser as to how similar transactions have been handled in the past by the IRS and the courts. Doing so will also provide the taxpayer with an argument that any unused reports or correspondence are privileged, as the appraisal was intended to assist the attorney in rendering legal advice. As noted above, this argument is not as strong in the "planning" stage. At the audit and litigation levels however, the attorney can argue that the documents are work product.

b. Anything Committed to Writing May Be Discoverable.

Any document in the appraiser's file, including correspondence, notes, and drafts of an appraisal is subject to being discovered during the audit process or in subsequent litigation. Experienced appraisers should know this; however, it never hurts to remind them. Once again, consider who your audience may ultimately be and understand that the appraiser's file may be reviewed by the examining agent, appeals officer, district counsel, or the ultimate finder of fact in tax litigation.

c. Discuss the Methodology and Results of the Appraiser's Work With the Appraiser Before the Appraiser Drafts the Report.

Hiring a qualified appraiser is only the first part of the job. Examine the underlying assumptions, analysis, and conclusions of the appraiser and ensure that they are logical. Appraisers can and do make mistakes. Discuss with the appraiser his or her methodology of his or her examination *before* the appraiser commits the findings to writing. This doesn't mean you should "coach" the appraiser or tell the appraiser the answer that you want; it does mean that you should satisfy yourself that the appraiser's assumptions and analysis are correct. If you have questions or concerns regarding the appraiser's assumptions or analysis, you should discuss those concerns with the appraiser before the appraiser begins drafting the report. If your concerns cannot be satisfied, consider choosing another appraiser. If you decide to engage a second appraiser *before* the first appraiser has reduced his findings to writing, there will be no documents from that appraiser to produce in response to an examining agent's request for "copies of all appraisals."

D. Put Your Client in a Position to Produce Correspondence or Documents in Your File if It Is in the Client's Best Interest to Do So.

The assertion of the privileges at the audit or tax court level lead to an inference that the taxpayer is hiding something. Arguing that a document should be shielded from discovery by an examining agent or district counsel because it is either subject to the attorney client privilege or was prepared in anticipation of litigation may have evidentiary implications. *See, e.g., Estate of Shoemaker v. Comm'r,* 47 T.C.M. (CCH) 1462, 1464 n.7 (1984) ("Prior to trial, respondent sought discovery of estate planning files of Mr. Parsons' law firm pertaining to decedent. The attorney-client privilege was asserted and sustained by us, although we invited attention to the possibility that an unfavorable inference could be drawn from this assertion of the privilege.").

In cases where the IRS questions motives or business purpose, the best evidence can come from the correspondence prepared in connection with the transaction at issue. Well-drafted contemporaneous correspondence outlining the business and financial reasons (*i.e.*, the nontax reasons) for the transaction being challenged, such as a buy-sell agreement or the creation of a family limited partnership or corporation, serve as wonderful evidence to rebut an argument from the IRS that an entity was created as "a device solely to avoid taxes" or lacks "business purpose." *See, e.g., John J. Wells, Inc. v. Comm'r,* 47 T.C.M. (CCH) 1114, 1116 (1984). ("While obviously the true facts can never be known with complete certainty by an outsider. . . . We base our conclusion upon our view of the spoken testimony and how that testimony, coupled with the documentary evidence, comports with human experience.").

E. The Effect of Asserting the Privilege on the Burden of Proof in Disputed Cases.

In certain cases, the taxpayer can shift the burden of proof in transfer tax cases from the taxpayer to the government in the Tax Court. *See* I.R.C. § 7491. Section 7491 provides:

> (a) burden shifts where taxpayer produces credible evidence.–
>
> (1) GENERAL RULE.–If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.
>
> (2) limitations.–
>
> (A) the taxpayer has complied with the requirements under this title to substantiate any item;
>
> (B) the taxpayer ***has maintained all records required under this title and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews***; and
>
> (C) in the case of a partnership, corporation, or trust, the taxpayer is described in section 7430(c)(4)(A)(ii).
>
> Subparagraph (C) shall not apply to any qualified revocable trust (as defined in section 645(b)(1)) with respect to liability for tax for any taxable year ending after the date of the decedent's death and before the applicable date (as defined in section 645(b)(2)).
>
> (3) COORDINATION.– Paragraph (1) shall not apply to any issue if any other provisions of this title provides for a specific burden of proof with respect to such issue.

I.R.C. § 7491 (emphasis added).

To shift the burden of proof, the taxpayer must have complied with the substantiation requirements and kept the required records. In addition, the taxpayer must have cooperated with "reasonable requests" by the IRS for "witnesses, information, documents, meetings, and interviews" and must present "credible evidence" in court on the factual issue before the burden shifts. If the taxpayer asserts the privilege in response to an IRS request for information, the IRS will obviously argue that the taxpayer has not cooperated fully enough in providing information and should not be able to shift the burden of proof. The question yet to be addressed by the courts is whether a request that seeks privileged information can ever be "reasonable."

However, the Tax Court recently determined that a taxpayer did not fail to reasonably cooperate simply because it filed a motion to quash a summons that the IRS had issued to obtain certain documents during discovery. The court found that the taxpayer "had a good faith belief that some of the documents respondent sought were irrelevant, sealed, or contained sensitive . . . business information and filed a motion to quash the summons to protect its rights. Once the court denied the estate's motion to quash, the estate provided the documents respondent requested. Respondent has not argued that respondent's investigation was impaired by any lack of documentation." *Estate of Kohler v. Comm'r.*, T.C. Memo 2006-152 (July 25, 2006).

F. Privilege versus Penalty.

Ironically, the price of asserting the privilege in particular cases may be the loss of other rights that would otherwise be available to the taxpayer or to the tax preparer. For instance, claiming the privilege may prevent taxpayers from showing that they have had substantial authority for a return position to avoid an accuracy related penalty, or prevent tax preparers from protecting themselves from tax preparer penalties.

Specifically, I.R.C. § 6662(a) imposes an accuracy related penalty in an amount equal to 20% of the portion of any underpayment to which the section applies. The section applies to, among other items, the portion of an underpayment attributable to negligence or disregard of rules or regulations. I.R.C. § 6662(b)(1). Negligence has been defined as the lack of due care or failure to do what a reasonable and ordinary prudent person would do under the circumstances. *Neely v. Comm'r*, 85 T.C. 934, 947 (1985). Negligence includes the failure to make a reasonable attempt to comply with the Internal Revenue Code. I.R.C. § 6662(c).

One defense to an underpayment penalty is that the underpayment of tax was made in good faith and due to reasonable cause. Whether an underpayment of tax is made in good faith and due to reasonable cause will depend upon the facts and circumstances of each case. Treas. Reg. 1.6664-4(b). However, reliance on the advice of professional accountants or attorneys in preparing tax returns constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. *Id. See, e.g., Schauerhamer v. Comm'r*, 73 T.C.M. (CCH) 2855 (1997). In order to demonstrate reasonable reliance, the taxpayer may need to disclose what might otherwise be privileged information. Accordingly, each case should be looked at on its own merits to determine whether or not the client will benefit by disclosure.

As a general matter, if the transaction is not a tax shelter under section 6662, the taxpayer may avoid understatement penalties if it has substantial authority for its position. It is not necessary to have a legal opinion *per se* as long as it is possible to demonstrate the existence of substantial authority.

If it is a tax shelter, then the taxpayer must have reasonable cause for its position and have taken such position in good faith. I.R.C. § 6662(d)(2)(B); I.R.C. § 6664(c). Until recently, most believed that a more likely than not opinion from a law firm would satisfy this standard. Care needs to be taken on the accuracy of the factual representations and the structure of the opinion to ensure that reliance on such opinion would constitute reasonable cause. *See* Circular 230; Treas. Reg. § 1.6664-4. Also, while so called "short form" opinions may provide more comfort with respect to privilege concerns, they also may provide less comfort with respect to penalty concerns.

Reasonable cause may also exist, even though an outside legal opinion was not obtained, based on an analysis of the legal issues by employees of a company. To the extent in-house company lawyers review the tax issues, communications with such lawyers may also be privileged but it is important to demonstrate that such company lawyers, among other requirements, were acting in their legal and not business capacities. *See generally Upjohn v. United States*, 449 U.S. 383 (1981).

If a taxpayer relies on the opinion of counsel to avoid penalties, the taxpayer must produce such opinion and thereby waive its privilege, which could be interpreted as a broad subject matter waiver. *In re G-I Holdings*. If the opinion was procured only to avoid penalties, there is the further risk that such opinion did not enjoy a privileged status in the first instance.

The Section 7525 privilege does not apply to tax shelters, which would probably include listed transactions. Also, the IRS's current practice is to ask for audit work papers only if the transaction is a listed transaction. Ann. 2002-63. In terms of avoiding penalties, the taxpayer must have disclosed the listed transaction on its tax return pursuant to the reportable transaction regulations in order to rely upon the reasonable cause defense. Treas. Reg. § 1.6664-4(d). Finally, producing an opinion to avoid penalties will waive the privilege. *In re G-I Holdings*. It is also possible that obtaining an opinion solely to avoid penalties will also waive the privilege.

In *Johnston v. Comm'r*, 119 T.C. No. 3 (August 8, 2002), the Tax Court held that the taxpayer impliedly waived the attorney-client privilege by raising a claim that could be effectively disproven only through discovery of privileged information. The Johnstons rebutted fraud penalties with the defense of reasonable reliance on qualified experts in preparing income tax returns. Relying on *Hearn v. Rhay*, 68 F.R.D. 574, 581 (E.D. Wash. 1975), the *Johnston* court acknowledged four approaches[13] to implied waiver analysis, and focused on the three factors of the *Hearn* test to determine whether the privilege had been impliedly waived: (1) assertion of the privilege must be the result of an affirmative act – in other words, the privilege is implicated in the context of an affirmative defense; (2) as a result, the privileged information has been put at issue by the person asserting the privilege by making it relevant to the case; and (3) upholding the privilege would deny the opposing party access to information vital to his defense (sometimes termed a "sword and shield" approach). For a discussion of the "sword and shield" analysis, see *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1162 (9th Cir. 1992).

G. Where Are We Now?

Recent opinions have dealt a significant blow to the lack of economic substance, lack of business purpose, I.R.C. § 2703, I.R.C. § 2704(b) and gift on formation positions taken by the IRS in the family limited partnership area. Subject to the continuing development of case law and § 2036, if a partnership is valid under applicable state law and the entity is respected by the partners, the Tax Court will recognize that entity for transfer tax purposes. In fact, the § 2036 cases where the IRS has successfully disregarded the existence of an entity involve

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[13] The other three approaches were: (1) the automatic waiver rule – whereby a party automatically waives the privilege by asserting a claim or defense to which otherwise privileged material is relevant; (2) a balancing test – weighing the need for discovery against the underlying rationale for the privilege; and (3) a more protective waive theory whereby the privilege is waived only if the party directly injects an attorney communication into issue.

situations where the Tax Court has found that the partners have not respected and treated the partnership as a separate legal entity for state law purposes.

In light of these decisions, the IRS is primarily left arguing over the value of the partnership interest or, in cases where the entity has not been respected or where the Decedent retained a significant amount of control, an argument that the entity should be ignored under I.R.C. § 2036. In dealing with the IRS at the audit level and in litigation, I have seen the IRS increase its focus on the actual operations of the partnership. The IRS routinely requests the opportunity to examine the books and records of the partnership, the partnership's bank statements, and the documents conveying assets into the partnership. If distributions were made, were they made in accordance with the terms of the partnership agreement? Was the partnership operated as a separate legal entity, or merely a second bank account for the decedent? The IRS is inquiring, as did Judge Cohen in the *Estate of Strangi* opinion, whether the proverbial "i's are dotted and t's are crossed?" The IRS attacks on partnership based valuation discounts can be thwarted with careful planning, documentation and operation of the entity. This includes ensuring that the partners respect the entity and that qualified, supportable, and well reasoned appraisals are obtained when valuing the transferred interests.

Valuation discounts for lack of control and lack of marketability are real. A person acquiring an interest in a family limited partnership, particularly a non-controlling interest, lacks the ability to dictate how the partnership will be run and how distributions will be made. There is no established market on which the interest can be traded.

As can be seen from the table set forth below, taxpayers have sustained substantial valuation discounts in cases where the Court found their expert's valuation testimony more persuasive than the valuation testimony presented the government. Practitioners must remember that the valuation report is the most important piece of evidence in a transfer tax dispute. Because the valuation filed with the transfer tax return constitutes an "admission" of value by the taxpayer, it is important for the taxpayer to obtain well-reasoned appraisals from a qualified appraiser ***when the return is filed***.

Case	Assets	Discount from NAV/Proportionate Entity Value
Strangi I	securities	31%
Knight	securities/real estate	15%
Jones	real estate	8%; 44%
Dailey	securities	40%
Adams	securities/real estate/minerals	54%
Church	securities/real estate	63%
McCord	securities/real estate	32%
Lappo	securities/real estate	35.4%
Peracchio	securities	29.5%
Deputy	boat company	30%
Green	bank stock	46%
Thompson	publishing company	40.5%
Kelly	cash	32%

Internal Revenue Service Department of the Treasury

Date:

In Reply Refer to:

Person to Contact:

Contact Telephone Number:

Fax Number:

Re:

Dear

The United States Gift Tax Return you filed for the year _____ is being audited by this office. We need the information listed below furnished or made available for our inspection within the next three (3) weeks:

1. Copies of donor's Federal Income Tax Returns (1040) for the year before, the year of and the year after the gift referenced above.

2. Copies of all 709's filed with with appraisals, acts of donation and other supporting documentation. This includes 709's filed by your spouse.

3. If any assets subject to any of the above referenced gifts have been sold or agreements to sell have been entered into subsequent to date of donation please provide complete details, including contracts, deeds and closing statements.

4. A list of donations of any kind, other than customay holiday and birthday gifts of small value, made during your life time regardless of whether a Gift Tax Return Form 709 was filed.

5. If the object of any of the above donations was an interest in any closely held corporation, partnership, limited liability company or other business organization, we need the following:

a) All documents relating to the creation of the entity (including bills) from any attorney, accountant or firm involved in recommending the creation of the entity or in drafting the necessary documents. If a claim is made that any of these documents are privileged, identify each privileged document by date, source, audience, and reason for the privilege.
b) Articles of organization and operating agreement, with any amendments.
c) All documents that were prepared to meet state law requirements on the formation and operation of the entity.
d) All financial statements and tax returns prepared and/or filed since inception.
e) All of the entities' bank and other records (i.e., general ledger, cash receipts and disbursements journals, check registers, etc.) which reflect the amount and nature of all deposits and distributions, including distributions to owner/members, for the period since the entity was formed to the current period.
f) Minutes of all meetings; if none, indicate the dates of all meetings and the business discussed.

g) Evidence showing how the value of each entity asset was arrived at as of the date:
   1. it was contributed to the entity;
   2. of each gift of a interest in the entity;

provide all appraisals and supporting workpapers.

h) Evidence as to how the entity was valued as a whole as well as fractional interest. Provide all appraisals if not already furnished.

i) Evidence to substantiate all initial and subsequent capital contributions and the source of all contributions by owners other than the donor.

j) For any entity asset that has been sold or offered for sale since the formation of the entity, provide evidence which documents the sale or attempted sale (i.e., sales agreement, listing agreement, etc.).

k) For each entity asset, explain/provide:
   1. evidence that the entity owns the asset;
   2. when the donor acquired the asset;
   3. how the asset was used by the donor since its acquisition and how the entity has used the asset since; and
   4. who managed the asset prior to and after its contribution, explain in detail what management consisted of and how it changed after the entity was formed.

l) Brokerage statements reflecting the ownership and activity of the securities and mutual funds contributed to the entity for the period beginning one year prior to the formation of the entity and continuing through the current date, and copies of any other tax returns and financial statements which reflect the activity of the entity's assets, if different from the foregoing.

m) For each gift or transfer of an interest, provide:
   1. evidence that the interest was legally transferred under state law and under the terms of any agreement among the owner/members.
   2. any assignment of any interest along with the terms of the assignment;
   3. the amount and source of any consideration paid along with an explanation as to how the amount was arrived at.

n) Provide the following with respect to the donor, all other original members and any recipients of gifts or transfers of interests:
   1. date of birth;
   2. education and occupation;
   3. experience and expertise in dealing with real estate, financial affairs and investments;
   4. extent of the donor's investments as of the date of the formation of the entity, including a summary of assets that were not contributed to the entity; provide tangible evidence thereof; and
   5. any personal financial statements and credit applications which were prepared in connection with loan applications after the LLC was created.

o) Indicate whether the entity is currently in existence, and, if so, provide the current ownership interests.

p) Provide a summary of any other transfers of business interests not reflected in the gift tax returns filed.

q) A statement describing the donor's state of health at the time of the formation of the entity and for the six month period prior thereto, including a description of any serious illnesses. Please also provide the names, addresses and telephone numbers of all doctors who would have knowledge of the donor’s state of health during this period to the present date and provide these doctors with authorization to respond to the Service’s future requests for information, including a copy of the medical records, in necessary.

r) A copy of the Donor’s will, revocable trust, and any executed power of attorney, if not submitted with the return.

s) A statement indicating the identity of the parties recommending the use of the LLC or partnership, when the recommendations were made, and the reasons set forth in support of using such an entity.

t) Names, addresses, and current telephone numbers of the representatives of the Donor/Estate, all donees/beneficiaries, all partners or members, accountants/bookkeepers, and brokers/investment advisors.

Each item should be responded to either by furnishing the requested documentation; a written response, if called for, under the signature of the donor or a written explanation as to why the information will not be provided.

Should you have any questions call or write to me at he above number and address. A Form 2848 is enclosed for for your execution if you wish to appoint your attorney or CPA to represent you.

Very truly yours,

Enclosures:
IRS Publication 1
Form 2848 Power of Attorney