RECENT CASES AFFECTING
FAMILY LIMITED PARTNERSHIPS AND LLCs

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

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TABLE OF CONTENTS

Page

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Luce, Forward, Hamilton & Scripps LLP
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1. ***Estate of Rector v. Commissioner***, T.C. Memo 2007-367

a. Facts of the Case

Mrs. Rector, a widow, died on January 11, 2001 at the age of 95, survived by two sons, John and Frederick. John was a licensed investment broker and had extensive financial experience. At the death of Mrs. Rector's husband in 1978, a bypass trust was created that provided for the income to be paid to Mrs. Rector and principal to be paid for Mrs. Rector's care and support, but only if the assets in the marital deduction trust also created when Mrs. Rector's husband died could not be readily used for her care and support. The marital deduction trust included one-half of the husband's estate, plus Mrs. Rector's separate property and her one-half of the community property. Mrs. Rector subsequently transferred the assets in the marital trust to a new revocable trust in 1991, when she was 85. In October 1998, at the age of 92, Mrs. Rector became a full-time resident of a convalescent hospital.

In December of 1998, Mrs. Rector formed a limited partnership. Her son, John, had learned of the idea from his estate planning attorney. There were no negotiations over the terms of the partnership agreement. According to Judge Laro, Mrs. Rector and her sons intended that Mrs. Rector would make the only contributions to the partnership.

In March of 1999, Mrs. Rector transferred $8.8 million of cash and marketable securities through her revocable trust to the limited partnership in exchange for a 98% limited partnership interest held in the revocable trust and a 2% general partnership interest held by her individually. At the time the limited partnership was funded the bypass trust assets had a value of approximately $2.5 million.

The partnership agreement provided that the general partners had the absolute management and control of the business and affairs of the partnership. It also provided the net cash flow, as defined in the agreement, was to be distributed to the partners in proportion to their partnership interests.

In the same month that Mrs. Rector funded the partnership, she made gifts of an 11.1% limited partnership interest to each of her two sons. She later assigned her 2 % general partnership to her revocable trust on January 2, 2001. She then gave an additional 2.754% interests to each of her sons on January 4, 2001, leaving her revocable trust the owner of the 2% general partnership interest and a 70.272% limited partnership interest. Mrs. Rector died on January 11, 2001.

The partnership operated without a business plan or an investment strategy, nor did it trade or acquire investments. There were no balance sheets, income statements, or other financial statements and no formal meetings. According to Judge Laro, the partnership functioned to own investment accounts, make distributions, and pay Mrs. Rector's personal expenses. The partnership did maintain monthly statements of investment account activity and a handwritten check register for payments, but did not maintain statements of activity and capital accounts.

Distributions in its first three years to its partners exceeded the partnership's income by almost $500,000. During 1999 and 2000, 86 to 90% of the distributions were made to Mrs. Rector to pay her living expenses. Mrs. Rector's only income outside of distributions from the partnership was from the bypass trust, which was about $45,000 a year from 1998 until her death. During her life, checks were written from the partnership to her revocable trust that were used to pay her gift tax liabilities, and after her death checks were written from the partnership to pay her federal and state estate tax liabilities.

At the time of her death in 2001 at the age of 95, the partnership assets had a value of $8,126,579. The estate claimed a 19% discount for lack of control and lack of marketability on the estate tax return. The IRS issued a deficiency notice asserting a $1,633,049 federal estate tax deficiency, based on the inclusion of the partnership assets in her estate under I.R.C. § 2036(a)(1).

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

Judge Laro held that, based on the record, the limited partnership was formed to facilitate the transfer of Mrs. Rector's property to her sons and grandchildren primarily as a testamentary substitute, with the aim of lowering the value of her gross estate by applying discounts for lack of control and lack of marketability. In finding that Mrs. Rector and her sons had an understanding that she would retain her interest in the transferred assets, Judge Laro noted that she retained control of the distribution of the partnership's cash flow as the general partner. In addition, she transferred practically all of her wealth to the partnership and derived economic benefit from using the partnership's assets to pay her living expenses, to meet her tax obligations (including the payment of federal and state estate taxes after her death), and to make gifts to her family members. Judge Laro rejected the estate's argument that her assets were sufficient to meet her needs because of the $2.5 million in the bypass trust. He noted that the bypass trust only permitted distributions of principal for her care and comfortable support in her accustomed manner of living. According to Judge Laro, the understanding among Mrs. Rector and her sons was that the principal of the bypass trust would not be invaded.

In finding that the transfer did not satisfy the bona fide sale exception, Judge Laro pointed out that, because the formation of the partnership entailed no change in the underlying pool of assets or the likelihood of profit, the receipt of the partnership interests did not constitute the receipt of full and adequate consideration. In finding that the transfer of the assets to the partnership were not made in good faith, Judge Laro noted that Mrs. Rector's sons did not negotiate the terms of the partnership agreement (although other cases have not made this an absolute requirement), Mrs. Rector made all the contributions, and her contributions constituted the vast bulk of her wealth, the partnership was formed with Mrs. Rector and her revocable trust as the only partners; the partnership was not funded until nearly three months after it was formed (which, by itself, should not matter); although the agreement contemplated more than one partner would contribute to the partnership, it was intended that she would make the only contributions; and there was no significant nontax business purpose at its inception. Judge Laro adds the word "business" when he describes the standard that should apply, although other cases have simply required a legitimate and significant nontax purpose.

Judge Laro dismissed the estate's reasons for forming the partnership, which were to benefit from estate tax savings, to give away partnership interests, to protect Mrs. Rector's assets from creditors, and to diversify her assets. According to Judge Laro, gift giving is testamentary, there was no evidence that the assets transferred required any special kind of management, there was no evidence to establish any legitimate concern about the liabilities of Mrs. Rector (and as a general partner her assets were not protected), and there was no investment strategy or business plan. Based on his rejection of the estate's reasons for forming the partnership, and Mrs. Rector's age and health, as well as the fact that only cash and marketable securities were contributed, Judge Laro concluded that the formation of the partnership was more consistent with an estate plan than an investment in a legitimate business, and that the bona fide sale exception did not apply.

In addition to the increase in the estate tax, the IRS imposed an accuracy related penalty on the estate because of the failure to report the 1991 and 1999 gifts of $595,000 and $70,000, respectively, as adjusted taxable gifts on the estate tax return. Judge Laro agreed with the IRS' assessment of the penalty based on the fact that John Rector, who signed the return as co-executor of the estate, had extensive expertise in financial matters. Judge Laro believed he should have known about the omission in his capacity as co-executor and as the donee of half of the gifts. Furthermore, the estate made no showing of reasonable cause or good faith with respect to the omission.

c. Analysis of the Court's Opinion

The result in this case is not surprising, considering the facts. Nonetheless, some of Judge Laro's statements concerning the application of the law to the facts are inconsistent with earlier cases. For example, his mention of a "business" purpose is in contrast to the lack of any "business" purpose in the *Schutt* case, in which the taxpayer was successful because the business trusts were formed to carry out the decedent's investment objectives. In addition, his finding that there were no negotiations as a factor indicating the transfer of assets was not made in good faith has not been followed in many other cases, notably *Kimball*.

Finally, his opinion does not assist in determining which transfers are subject to 2036(a). In every case involving I.R.C. § 2036(a), there is at least one transfer, that is by the decedent, and perhaps others, to the entity in exchange for interests in the entity. In addition, there may be additional transfers during the decedent's lifetime in the form of gifts (or purported sales at fair market value that turn out to be part sale/part gift transactions). It is unclear under the decisions dealing with I.R.C. § 2036(a), whether that section applies to the first or second transfer or to both transfers. If I.R.C. § 2036(a) applies to the first transfer, because the bona fide exception does not apply, and the decedent retained, even after subsequent gifts of interests in the entity, either the enjoyment of the income from all the transferred assets or the right to designate the persons who would enjoy the income from all the transferred assets, then subsequent gifts should not diminish the amount included in the decedent's estate under I.R.C. § 2036(a).

On the other hand, if the decedent's enjoyment of the income or right to designate the persons who would enjoy the income was effectively reduced as a result of the gifts, which was probably not the likely scenario in most of the decided cases in favor of the IRS, then the portion of the assets attributable to the transferred interests would not be includable in the decedent's estate if the decedent lived for three years after the transfer (thereby avoiding I.R.C. § 2035(a)). In most cases the courts have found that the decedent continued to enjoy the income from all the assets until the decedent's death. Note that the subsequent gifts of the interests in the entity would not qualify under the bona fide sale exception because they are gifts.

In a footnote rejecting the estate's argument that I.R.C. § 2036(a) only applied to the transfers of the limited partnership interests to her sons and not to her transfer of the assets to the partnership, Judge Laro treated the transfer to the partnership and the subsequent gifts as part of a single plan to minimize Mrs. Rector's estate tax that lacked a significant nontax business purpose, and accomplished no genuine pooling of assets. Judge Laro could have simply stated that the original transfer was the determinative transfer and, as long as Mrs. Rector continued to enjoy the income form all the assets in the partnership under an implied agreement, I.R.C. § 2036(a) applies to all the assets.

This case is another example that the criteria are similar in determining whether the bona fide sale exception applies and whether there has been an implied agreement that the decedent would continue to enjoy the income from the assets. Many of the same factors are considered for both issues. In fact, if an opinion starts out by discussing the bona fide sale exception, the taxpayer has won. If the opinion starts out discussing the implied right to enjoy the income issue, the taxpayer has lost. If the facts warrant a finding of an implied right, the same facts would usually lead to the conclusion that the bona fide sale exception does not apply.

2. ***Estate of Mirowski v. Commissioner***, T.C. Memo 2008-74

a. Facts of the Case

Ms. Mirowski died at the age of 73 on September 11, 2001 (9/11). She was a widow. Her husband died in 1990. He was the inventor of the automatic implantable cardioverter defibrillator (ICD) (commonly referred to as a pacemaker) and was entitled to 73% of the royalties from the ICD patents, which he left to Ms. Mirowski. She created separate irrevocable trusts in 1992 for each of her three daughters, and transferred approximately 7% of the ICD patent royalties to each of the trusts. After considering it for a year, Ms. Mirowski formed the Mirowski Family Ventures L.L.C. (MFV) under Maryland law on August 27, 2001. She then transferred her remaining interest in the ICD patent royalties to MFV on September 1, 2001, and then transferred approximately $62 million of marketable securities to MFV in three transfers on September 5, 6, and 7, 2001. On September 7, 2001, she made gifts of a 16% interest in MFV to each of the irrevocable trusts she had earlier created for each of her three daughters, leaving her with a 52% interest in MFV. Judge Chiechi noted Ms. Mirowski never contemplated forming MFV without making the gifts to her daughters' trusts. Although Ms. Mirowski had diabetes and had developed a foot ulcer, at no time before September 10, 2001, did she, her doctors, or her daughters think her death was imminent. The IRS asserted a deficiency of approximately $14.2 million, based on including all the assets in MFV in her estate under I.R.C. §§ 2036(a), 2038(a)(1), and 2035(a).

b. Court's Opinion

Judge Chiechi, who also decided *Estate of Stone v. Commissioner*, T.C. Memo 2003-309, another taxpayer victory in an FLP case, held that the bona fide sale exception applied to the transfers to MFV by Ms. Mirowski and that Ms. Mirowski did not retain the enjoyment of the income from the transferred assets nor the right to designate who was to enjoy the income from the transferred assets, and therefore, 2036(a), 2038(1), and 2035(a) did not apply. Her decision was based on the facts in the case, the testimony of two of the daughters, the terms of the MFV operating agreement, and Maryland law. At the outset, Judge Chiechi determined that the resolution of the issues presented did not depend on who had the burden of proof. It seems that none of the cases dealing with the application of I.R.C. § 2036(a) have been decided on the basis of who had the burden of proof.

The facts of the case indicated that Ms. Mirowski, from her childhood in France, had always been concerned with keeping her family together. She placed a great deal of emphasis on having the family make decisions collectively. Nonetheless, she made her own investment decisions, even up to her death.

Judge Chiechi found the testimony of the two daughters who served as witnesses concerning the facts in the case, including the reasons for forming and transferring assets to MFV, to be completely candid, sincere, credible, and reasonable.

Judge Chiechi also pointed to the terms of the MFV operating agreement that precluded Ms. Mirowski from having the right to enjoy the income from the transferred assets or to designate who would enjoy the income from those assets.

Finally, Judge Chiechi relied on Maryland law in determining that Ms. Mirowski did not retain the right to enjoy the income or designate who would enjoy the income from the transferred assets.

Judge Chiechi determined that for I.R.C. § 2036(a) to apply, there had to be a transfer of property, the bona fide exception did not apply, and Ms. Mirowski must have retained the right to the income or the right to designate who would enjoy the income from the transferred property. Judge Chiechi also treated the transactions as two separate transfers: the transfers Ms. Mirowski made to MFV and the gifts she made to her three daughters.

Bona fide sale exception.

Based on the testimony of two of Ms. Mirowski's daughters, Judge Chiechi found that Ms. Mirowski had the following legitimate and significant nontax reasons for forming and transferring certain assets to the partnership:

(1) Joint management of the family's assets by her daughters and eventually her grandchildren;

(2) Maintenance of the bulk of the family's assets in a single pool of assets in order to allow for investment opportunities that would not be available if Ms. Mirowski were to make a separate gift of a portion of her assets to each of her daughters' trusts; and

(3) Providing for each of her daughters and eventually each of her grandchildren on an equal basis.

Significantly, Judge Chiechi stated in a footnote that the first reason alone would have been sufficient to satisfy the requirement under the bona fide sale exception that there must be a legitimate and significant nontax reason for creating the entity. In addition, she rejected the IRS' contention that the facilitation of lifetime giving may never qualify as a significant nontax reason for forming and funding a family entity. While the Tax Court in *Bongard v. Commissioner,* 124 T.C. 95 (2005) held that lifetime giving was not a significant nontax reason for forming the partnership, according to Judge Chiechi that holding was based on the facts in that case and was not a holding that lifetime giving may never be a significant nontax factor. Judge Chiechi also found that there was a fourth nontax reason for forming and funding MFV; namely, for asset protection. Although she noted Ms. Mirowski's concern about creditors of her daughters, Judge Chiechi concluded that the trusts Ms. Mirowski established for them provided ample protection.

The government offered the following contentions in challenging the bona fide sale exception, based on case law:

(1) Ms. Mirowski failed to retain sufficient assets outside of MFV for her anticipated financial obligations;

(2) MFV lacked any valid functioning business operation;

(3) Ms. Mirowski delayed forming and funding MFV until shortly before her death and her health had begun to fail;

(4) Ms. Mirowski sat on both sides of her transfers to MFV; and

(5) After Ms. Mirowski died, MFV made distributions totaling over $36 million to pay her federal and state transfer taxes, legal fees, and other estate obligations.

Judge Chiechi rejected each of these contentions, as follows:

(1) The only anticipated significant financial obligation of Ms. Mirowski when she formed and funded MFV was the substantial gift tax for which she would be liable because of the gifts she made. There was no express or implied agreement that MFV would distribute assets to pay the gift tax liability. In addition, there were three options available for paying the gift taxes: (a) use of a portion of the $7.5 million (including $3.3 million in cash and cash equivalents) she retained; (b) use of the expected substantial distributions (attributable in large part to the royalties from the ICD patents) she would receive from MFV as a 52% interest holder; and (c) loans using her retained assets or her interest in MFV as collateral. In addition, because until September 10, 2001, none of Ms. Mirowski, her daughters, or her physicians expected her to die, there were no discussions or expectations that transfer taxes would be soon be due.

(2) MFV at all relevant times was a valid functioning investment operation and had been managing the business matters relating to the ICD patents and the ICD patents license agreement, including related litigation. Specifically, Judge Chiechi rejected the government's contention that the level of activities must rise to a level of a "business" for the bona fide sale exception to apply.

(3) Based on the same facts discussed with regard to the payment of estate taxes, because Ms. Mirowski's death was unexpected, Judge Chiechi rejected the government's contention that the bona fide sale exception should not apply because the forming and funding of MFV was delayed until shortly before her health had begun to fail.

(4) The government's contention that another reason to reject the bona fide sale exception was the lack of negotiations between Ms. Mirowski and her daughters about the formation or funding of MFV would read out of the bona fide sale exception the creation of any single member LLC. In addition, Ms. Mirowski was the only contributor to MFV; the trusts for the daughters were only recipients of gifts of interests in MFV. In contrast, in *Estate of Rector v. Commissioner*, T.C. Memo 2007-367, Judge Laro noted the fact that Mrs. Rector was the only contributor as a negative factor.

(5) Because her death was unexpected the payment of transfer taxes and other estate obligations were not discussed or anticipated. Furthermore, Judge Chiechi rejected the government's suggestion that the payment of these obligations was determinative in this case of whether the bona fide sale exception applied.

Judge Chiechi also found that the cases relied on by the government were factually distinguishable from the instant case and the government's reliance on them misplaced. She also rejected the government's argument that, because Ms. Mirowski only ended up with 52% of the membership interests, she did not receive adequate and full consideration in the form of a proportionate interest. According to Judge Chiechi, Ms. Mirowski made two separate, albeit integrally related transfers of property: the transfers of assets to MFV and the gifts to the trusts for the benefit of her daughters. In return for her transfers to MFV, she received and held a 100% interest and had the right to a distribution of property from MFV in accordance with her capital account upon liquidation and dissolution of MFV.

Consequently, because Ms. Mirowski received an interest in MFV proportionately equal to the fair market value of her contribution (which in this case was 100%) and there were three legitimate and significant nontax reasons for forming and funding MFV, the bona fide sale exception applied.

Retained Right to Income

Because Ms. Mirowski's transfers to MFV were bona fide sales for adequate and full consideration in money or money's worth, it was unnecessary to deal with whether she retained the enjoyment of the income or the right to designate who would enjoy the income form the transferred property. However, because the gifts of the 16% interests to the three trusts for the benefit of her daughters were not bona fide sales, Judge Chiechi had to deal with those issues nonetheless.

The "linchpin" in the government's argument was that under the operating agreement Ms. Mirowski's authority included the authority to decide the timing and amounts of distributions from MFV. Based on the terms of the operating agreement and Maryland law, Judge Chiechi found the Ms. Mirowski's discretion, power, and authority as MFV's general manager were subject to fiduciary duties to the other members of MFV. The operating agreement provided for the distribution of cash flow, as defined in the agreement, within 75 days after the end of the taxable year, as well as the distribution of capital proceeds, as defined in the agreement. Consequently, Ms. Mirowski did not retain the possession or the enjoyment of, or the right to the income from, the respective 16% interests in MFV that she gave to her daughters' trusts.

As to whether there was an implied agreement, the government relied on essentially the same contentions that it relied on in rejecting the bona fide sale exception. These contentions had already been rejected. Judge Chiechi again pointed to fact that Ms. Mirowski's death was unexpected by Ms. Mirowski, her daughters, and her physicians, as the primary reason for rejecting the government's arguments. She also found an additional reason for rejecting the contention that the payment of estate taxes by MFV was determinative of whether Ms. Mirowski retained the enjoyment of the income from the transferred assets. The daughters decided not to make pro rata distributions to the trusts when distributions were made to the estate to pay taxes and other obligations, because, as equal beneficiaries of the estate, the trusts were benefiting from the payment of these estate liabilities equally. In effect, the distributions to pay estate taxes and other liabilities were pro rata distributions to the three trusts.

Judge Chiechi then turned to I.R.C. § 2036(a)(2). Based on the same analysis as she applied in rejecting the government's argument that Ms. Mirowski retained the right to the income, Judge Chiechi found she did not retain the right to designate who would enjoy the income.

Judge Chiechi then dealt with the remaining issues. I.R.C. § 2038(a)(1) did not apply for the same reasons that I.R.C. § 2036(a)(2) did not apply. In addition, because neither I.R.C. § 2036(a) nor 2038(a)(1) applied, the three year inclusion rule under I.R.C. § 2035(a) did not apply.

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

This case is in stark contrast to *Rector*, and to some extent, to some of the other cases that were IRS victories. Judge Chiechi rejected many of the positions advocated by Judge Laro in a number of cases he has decided dealing with FLPs. A legitimate and significant nontax reason does not have to include a business reason. Lifetime giving may be a significant nontax reason for creating the entity. Negotiations between the transferor and the donees of the interests in the entity are not a requirement in every case. There is no requirement that someone other than the decedent contribute assets to the entity. The payment of estate taxes and other post mortem obligations does not necessarily mean there was an implied agreement that the decedent would enjoy the income from the transferred property. The fact that the decedent depended in part on expected distributions from the entity, where it is clear the entity would have substantial income, does not indicate there was an implied agreement.

Fortunately for many situations where FLPs and FLLCs were created for both tax and legitimate and significant nontax reasons, but where the transferor died unexpectedly shortly after the formation and funding, Judge Chiechi's holdings and the reasons for the holdings should provide support for rejecting a challenge under I.R.C. § 2036(a) or 2038(a)(1).

However, because of Judge Chiechi's emphasis on Ms. Mirowski's family history, the unexpected death of Ms. Mirowski, and the credible testimony of two of Ms. Mirowski's daughters, as well as the terms of the operating agreement and Maryland law, this case should not provide solace in those situations where the entity was clearly formed as a tax savings device, and any nontax reason for creating the entity was a mere after thought and not a motivating factor.

The key factors in favor of the taxpayer in this case were (1) the unexpected death of Ms. Mirowski, (2) the family history, (3) the credible testimony of the daughters, (4) the existence of the ICD patents and the litigation associated with them, (5) the terms of the operating agreement that provided for the way distributions of operating and capital proceeds were to be made, (6) the substantial income MFV was expected to receive because of the ICD patent royalties, and (7) Ms. Mirowski's retention of over $7 million of assets.

3. ***Estate of Christiansen v. Commissioner***, 130 T.C. No. 1

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

This case upheld the effectiveness of a disclaimer of an interest in a decedent's estate over a specified dollar amount that passed to a charitable foundation as a result of the disclaimer. There were two other issues: whether the disclaimer was qualified with regard to an interest passing to a charitable lead annuity trust where the disclaimant possessed a contingent remainder interest and whether a savings clause with regard to the disclaimer of the interest in the charitable lead annuity trust was effective in rendering the disclaimer a qualified disclaimer. The Tax Court held that the disclaimer of the interest that passed directly to a charitable foundation was qualified and was not void as against public policy.

The Tax Court characterized the disclaimer in this case as involving a fractional formula that increased the amount donated to charity should the value of the estate be increased, and found it hard pressed to find any fundamental public policy against making gifts to charity. If anything, the opposite was true; public policy encourages gifts to charity and Congress allows charitable deductions to encourage charitable giving. The Tax Court rejected the government's argument, based on *Commissioner v. Procter*, 142 F.2d 824 (4th Cir, 1944), that voided a clause that reverted a gift to the donor if it were subject to gift tax, because (1) the provision would discourage collection of tax, (2) it would render the court's own decision moot by undoing the gift being analyzed, and (3) it would upset a final judgment. The Tax Court found that, in the instant case, the formula disclaimer would not undo a transfer, but only reallocate the value of the property transferred among the charitable and noncharitable beneficiaries, and, therefore, its decision would not be moot nor would the effect of its decision upset the finality of its decision.

The Tax Court recognized that its decision could marginally affect the incentive of the IRS to audit returns affected by such a disclaimer. However, the Court pointed to other mechanisms that would prevent abusive use of such formula disclaimers, including the fiduciary duty of executors and trustees, as well as directors of foundations. In addition, the IRS can go after fiduciaries who misappropriate charitable assets and, in most states, the state attorney general has the authority to enforce these fiduciary duties.

4. ***Holman v. Commissioner***, 130 T.C. No. 12 (2008)

a. Facts of the Case

Tom and Kim Holman (Tom and Kim), husband and wife, formed a limited partnership (the partnership) on November 2, 1999, and transferred shares of Dell Computer Corp. (Dell) to the partnership the same day. They each took back an .89% general partnership interest and a 49.04% limited partnership interest. In addition, a trust for the benefit of their children (the trust) transferred shares of Dell to the partnership for a .14% limited partner interest. They had four reasons for forming the partnership: very long-term growth, asset preservation, asset protection, and the education of their four children. In addition, they wanted to disincentivize their children from getting rid of the assets, spending them, or feeling entitled to them. The partnership agreement gave the general partners the exclusive right to manage and control the business and prohibited an assignment of an interest by a limited partner without the consent of all partners except to permitted assignees. The partnership agreement also gave the partnership the right to acquire an assignee interest acquired in violation of the agreement at fair market value based on the assignee's right to share in distributions. The partnership could only be dissolved with the consent of all partners.

On November 8, 1999, Tom and Kim gave limited partner interests (LP units) to the trust and to four uniform transfers to minors act custodianships for the benefit of their children (custodian accounts) having a reported value according to the gift tax returns roughly equal to their $600,000 transfer tax exemptions at the time. On December 13, 1999 the custodian accounts transferred additional shares of Dell to the partnership. On January 4, 2000, Tom and Kim gave LP units to the custodian accounts having a reported value equal to the annual exclusions available to Tom and Kim ($80,000). On January 5, 2001 Tom and Kim transferred additional shares of Dell to the partnership in exchange for additional LP units. Finally, on February 2, 2001, Tom and Kim gave additional LP units to the custodian accounts having a reported value equal to the annual exclusions available to Tom and Kim ($80,000).

The Tax Court described the operation of the partnership as follows: there was no business plan; there were no employees nor any telephone listing in any directory; its assets consisted solely of Dell shares; there were no annual statements; at the time Tom decided to create the partnership he had plans to makes gifts of LP units in 1999, 2000, and 2001; and the partnership had no income and filed no returns for 1999, 2000, and 2001.

The IRS increased the value of the gifts based on the following alternate assertions: the transfer of assets to the partnership were indirect gifts of the Dell shares; the interests were more analogous to interests in a trust than an operating business; I.R.C. § 2703 applied to ignore the restrictions in the partnership agreement; the restrictions on liquidations should be ignored under I.R.C. § 2704(b); and the appropriate discount for lack of control and lack of marketability should be 28%, rather than the taxpayer's 49.25% discount. At trial, the IRS abandoned the trust and I.R.C.§ 2704(b) arguments.

b. Court's Opinion

The following will deal with the Court's opinion with regard to the indirect gifts theory, the application of I.R.C. § 2703(a), and the value of the gifts for gift tax purposes. Note that, because this a gift tax proceeding, I.R.C.§§ 3036(a) and 2038 were not issues.

Indirect Gifts Issue. The IRS had asserted that, based on *Shepherd v. Commissioner*, 283 F.3d 1258 (11th Cir. 2002) and *Senda v. Commissioner*, T.C. Memo 2004-160, *aff'd* 433 F.3d 1044 (8th Cir. 2006), the gifts on November 8th were indirect gifts of the Dell shares, and therefore no discounts were appropriate. Based on the facts, the Tax Court distinguished the instant case because the shares were transferred six days after the partnership was formed and there was a real economic risk of a change in value between the date of formation and the transfer of the shares. The government had argued that the step transaction doctrine should have applied, because it was Tom's intent in forming the partnership to make the gifts. According to the Court, the fact that the government had not asserted that the gifts in 2000 and 2001 should also be treated as indirect gifts meant that government recognized that the passage of time could defeat a step transaction argument. According to the Court, because of the volatility of the Dell shares, six days was a sufficient period in the instant case.

I.R.C. § 2703 Issue. The IRS asserted that the right of the partnership to acquire an assignee's interest at a value less its pro rata share of the partnership's net asset value (NAV) should be disregarded under I.R.C.

§ 2703(a) because it did not satisfy the three requirements under the statutory safe harbor; namely, the right must be a bona fide business arrangement, it must not be a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth, and its terms must be comparable to similar arrangements entered into by persons in an arm's length transaction. The Court agreed with the government, based on its opinion that the right did not satisfy the bona fide business arrangement and device requirements.

The Court held that there was no closely held business and the reasons for forming the partnership were educating the Holman's children and disincentivizing them from getting rid of Dell shares, spending the wealth represented by the shares, or feeling entitled to the Dell shares. The Court distinguished *Estate of Amlie v. Commissioner*, T.C. Memo 2006-76, because in that case the conservator was seeking to exercise prudent management of his ward's minority interest in a bank consistent with his fiduciary obligations to the ward and to provide for the expected liquidity needs of her estate.

While the Court held that the gifts were not a device to transfer LP units for less than adequate consideration, the right to acquire an assignee's interest was such a device. The Court reasoned that by purchasing a transferred interest for a value less the a pro rata share of the NAV, the value of the non assigning children's LP units would be increased.

Although both parties' experts agreed that the restrictions were common in arm's-length arrangements, the government's expert believed that because of the nature of the partnership, nobody at arm's length would get into the deal. Because the Court found that the right to acquire an assignee's interest was not a bona fide business arrangement and was a device, it did not reach a conclusion as to whether the comparability requirement was satisfied.

<u>The Valuation Issue</u>. Because the partnership's only assets were the Dell shares, the experts for each party agreed on the value of the Dell shares at the date of the 1999 gift. The Court rejected the taxpayers' expert's argument that the valuation method under the gift tax regulations did not apply to the 2000 and 2001 gifts because the gifts were of partnership interests and not of the shares themselves. The Court also rejected the taxpayers' expert's contention that the lack of control discount should reduce the NAV based on the value of shares of publicly held investment companies that traded at a discount from NAV.

The Court essentially agreed with the government's expert's determination of the lack of control discount and arrived at a discount of 11.32% for the 1999 gifts, 14.34% for the 2000 gifts, and 4.63% for the 2001 gifts. Both experts relied on the prices of shares of publicly traded, closed-end investment funds, but disagreed as to whether useful information could be obtained by considering funds specializing in industries different from Dell and as to the range, mean, and median of the subset and the sample. The Court also rejected the taxpayer's expert's additional discounts for lack of portfolio diversity and professional management.

As for the appropriate lack of marketability discount, the Court agreed with the government's expert that a 12.5% discount was appropriate. Both experts agreed on the usefulness of restricted stock studies in determining the appropriate marketability discount for the gifts, that no secondary market existed for the LP units, that an LP unit could not be marketed to the public or sold on a public exchange, and that an LP unit can be sold only in a private transaction. They disagreed on the likelihood of a private market among the partners for the LP units.

The taxpayers' expert believed that there was no market for the LP units and that the lack of marketability discount should have been at least 35%. The government's expert observed that the taxpayers' expert's conclusion would lead to almost a zero value and the Court believed that the 35% figure was a guess. In contrast, the government's expert based his conclusion that a 12.5% lack of marketability was appropriate on the likelihood that a limited partner wishing to make an impermissible assignment of LP units and the remaining partners would strike a deal at some price between the discounted value of the units and the proportionate share of the partnership's NAV.

c. Analysis of Court's Opinion

The Court's discussion of the application of the step transaction doctrine will add additional confusion to an already confused area of transfer tax law. It could be argued that the step transaction doctrine should not apply at all to the transfer of assets to a partnership followed by gifts of interests in the partnership if the intent of the donor was to give partnership interests rather than the assets themselves for legitimate nontax reasons and the partnership was a valid entity under state law. If the Court's analysis is correct, practitioners will have to determine in each case how long the prospective donor must wait before making gifts of partnership interests, presumably based on the nature of the asset.

The Court's application of the statutory safe harbor under I.R.C. § 2703 greatly restricts its usefulness in family entities that do not engage in an active trade or business. The Court implies the bona fide business arrangement requirement can only be satisfied if there is a closely held business involved or the reasons for the restrictions are business related. Some commentators have argued that the Court ignores language in the Finance Committee Report that "[b]uy-sell agreements are commonly used to control the transfer of ownership in a closely held business…*to* *prevent the transfer to an unrelated party*" [emphasis added]. If the Court's premise is that the bona fide business arrangement requirement can only be met if there is a closely held business, which in its opinion does not include an investment in one company's stock, or the reasons for the restrictions are business related, the reasons for having any restrictions are irrelevant in meeting the requirement unless there is a closely held business or the reasons are business related.

Although the Court did not treat the gifts of the LP units themselves as a device, it held that the right to acquire an assignee interest at a value below its proportionate NAV could result in value being transferred to objects of the decedent's bounty for less than adequate consideration. However, the subsequent shift in value to the non-assigning children would not involve a transfer from the parents to the children, but merely a shifting of value among all the non-assigning partners. The result reached by the Court can be avoided by including a true right of first refusal rather than the provision giving the partnership the right to acquire an assignee's interest. Presumably the purchase price in a good faith offer by a third party would be based on a value considerably less than a pro rata share of the NAV.

Finally, as has been noted by other commentators, the willingness of the Court to accept testimony concerning the comparability requirement other than actual buy-sell agreements, which would be difficult to obtain for closely held businesses, is a welcome approach to that issue.

As for determining the lack of marketability discount, the Court strays from the hypothetical willing buyer and willing seller paradigm when it agrees with the government's expert's conjecture of how a partner wishing to dispose of his or her interest would strike a deal with the remaining partners. In supporting its position that the remaining partners would strike a deal, the provision in the partnership agreement permitting a dissolution by the consent of all the partners convinced the Court that preservation of family assets was not an unyielding purpose. The Court ignores the fact that under any state's partnership law a partnership can be dissolved if all the partners consent.

In conclusion, this case raises many issues that practitioners and their clients must consider when using business entities to carry out the clients' nontax objectives. Because the case was a regular Tax Court decision, the case has precedential authority.

5. ***Astleford v. Commissioner***, T.C. Memo 2008-128

a. Facts of the Case

On August 1, 1996, Jane Astleford (Jane), whose husband had died in 1995 leaving a number of real estate properties to a marital trust for Jane's benefit, formed a limited partnership (the partnership) and funded the partnership on the same day by transferring her interest in an elder-care assisted living facility. On the same day she gave each of her three children a 30% limited partnership interest. On December 2, 1997, Jane transferred to the partnership her 50% interest in a general partnership (Pine Bend) that was formed in 1970 by her husband and an unrelated third party and that owned 1,187 acres of agricultural farmland (the Rosemount Property) and 14 other properties, significantly increasing her general partnership interest and decreasing her children's limited partnership interests. In addition, on December 1, 1997 (the same day as the transfer of the properties described in the previous sentence), Jane gave each of her children additional limited partnership interests reducing her general partnership interests to 10% and increasing each of her children's limited partnership interest to 30%.

Although neither of these issues was raised by the government in this case, the facts raise both a lapse under I.R.C. § 2704(a) and an indirect gift under the step transaction doctrine. If the interests that Jane transferred were converted from general partnership interests to limited partnership interests, any diminution in value should have been treated as a gift. Because the 1996 and 1997 gifts were made on the same day as Jane transferred assets to the partnership, the IRS could have asserted that the step transaction doctrine should have applied to treat the transfers to the partnership as indirect gifts. In this case, because the assets were real property, a fractionalization discount would still have been appropriate.

b. Court's Opinion

The issues in the case were the value of the Rosemount Property, whether the 50% interest in Pine Bend should be valued as a general partnership interest or as an assignee interest, and the lack of control and lack of marketability discounts that should apply to the 50% Pine Bend interest and the gifted partnership interests.

The issues in determining the value of the Rosemount Properties included whether an "absorption" discount should apply and the appropriate discount rate. While the Court accepted the government's expert's starting value because he was particularly credible and highly experienced and possessed a unique knowledge of property located in the area, the Court agreed with the taxpayer's expert that an absorption discount was appropriate because of the size of the parcel and the likelihood that it would take four years to dispose of the property without reducing the price considerably. However, the Court used a 10% discount rate rather than the 25% discount rate advocated by the taxpayer's expert, which it believed was more in line with the return on investments experienced by farmers in the locality, thereby reducing the taxpayer's absorption discount from 41.3% to 20.396%.

The taxpayer treated the 50% Pine Bend interest as an assignee interest based on Minnesota law and the fact that the other general partner did not consent to the transfer. However, the Court agreed with the government that the substance over form doctrine should apply based on Jane's position as the sole general partner of the partnership, and the partnership's resolution that treated the Pine Bend transfer as a transfer of all of her rights and interests to the partnership. Because Jane was the sole general partner of the partnership, she would continue to have and to control the management rights associated with the 50% Pine Bend general partnership interest whether she transferred only an assignee interest or a general partnership interest.

The Court applied a combined 30% discount for lack of control and lack of marketability to the 50% Pine Bend general partnership interest. The Court rejected the government's argument that applying discounts to both the Pine Bend general partnership interest and the limited partnership interests gifted in 1996 and 1997 was inappropriate because the Pine Bend interest constituted less than 16% of the partnership's NAV and was only 1 of 15 real estate investments held by the partnership.

The Court applied a 16.17% lack of control discount and a 21.23% lack of marketability discount for the 1996 gifts and a 17.47% lack of control discount and a 22% lack of marketability discount for the 1997 gifts. In doing so, the Court relied on testimony from both experts. The taxpayer's expert relied on comparability data from sales of registered real estate limited partnerships (RELPs), while the government's expert relied on comparability data from sales of publicly traded real estate investment trusts (REITs). The Court used the RELP data to arrive at the discounts for Pine Bend and the REIT data to arrive at the discounts for the gifts, but made adjustments to the experts' valuation in each case.

c. Analysis of the Court's Opinion

Presumably, the IRS did not raise the indirect gift issue either on audit or at trial. After the Holman case, discussed above, it is likely that the IRS will challenge gifts made simultaneously or shortly after the formation of the partnership under the step transaction doctrine. Appraisers should find solace in the Court's acceptance of the taxpayer's argument that an absorption discount was appropriate, even though it cut the taxpayer's discount in half.

The second tier discount was warranted in this case for at least two reasons. First, as the Court pointed out, the Pine Bend interest constituted less than 16% of the partnership's assets. Second, although not cited by the Court, it was clear that Pine Bend was not formed to achieve another level of discounts because Pine Bend was formed by Jane's husband and a third party 36 years before Jane formed the partnership and made gifts of partnership interests to her children.

The determination of the appropriate discounts did not raise any unusual issues, but demonstrated the importance of using credible statistics to support an appraisal. The Court, as it often does, made adjustments to the experts' valuations in arriving at what it viewed as a more reasonable result.

6. ***Bianca Gross v. Commissioner***, T.C. Memo 2008-221

a. Facts of the Case

By 1998, Bianca Gross had acquired a sizable portfolio of publicly traded securities. After her husband's death in 1996, she had begun to consider her own mortality and her desire to involve her two daughters in managing what would someday become theirs, i.e., her securities portfolio. Because she deemed one of her daughters extravagant, she considered a trust arrangement, but rejected it because the other daughter declined to serve as a trustee. She settled on a family limited partnership, which she believed would encourage her daughters to work together and learn from her experience while preserving in her (as the general partner) control over the partnership's assets.

On July 15, 1998, Bianca and her daughters agreed to form a limited partnership in which each daughter would contribute $10 and she would contribute $100, plus securities. Bianca would be the general partner, would retain ultimate control over management of the partnership, including the authority to make decisions about sales, purchases, and other dispositions of the assets, and would have exclusive discretion concerning the timing and the amounts of distributions to the partners. The daughters would not be able to transfer their interests in the partnership without Bianca's approval, could not withdraw from the partnership or obtain a return of their capital contribution, and could not force a dissolution of the partnership.

On July 15, 1998, a certificate of limited partnership was filed with the New York Department of State. Later, a notice of the formation of the partnership was published in New York newspapers, as required by law, and on October 14, 1998, an affidavit of publication was filed with the New York Department of State. On July 31, the daughters wrote checks for $10 each to the partnership, and on November 16, 1998, Bianca wrote a check for $100 to the partnership. From the beginning of October until December 4, 1998, Bianca transferred to the partnership securities worth over $2.1 million, most of which were shares of well-known, publicly traded companies.

On December 15, 1998, Bianca and her daughters signed a limited partnership agreement that carried out the agreement they had entered into on July 15, and also executed deeds of gifts whereby Bianca transferred a 22.25% limited partnership interest to each daughter. The gifts were reported on gift tax returns taking into account a 35% discount for lack of control and lack of marketability.

The IRS issued a notice of deficiency treating the transactions as indirect gifts of the securities to the daughters rather than gifts of the limited partnership interests, thereby eliminating any discounts. The IRS argued that because the partnership was not formed until December 15, 1998, the transfers of securities occurred at the same time as the gifts were made. In the alternative, the IRS argued that the step transaction doctrine should apply because the transfers of the securities to the partnership and the gifts to the daughters were part of an integrated transaction.

b. Court's Opinion

The IRS argued that the limited partnership was formed on December 15, followed by the gifts to the daughters, and then the securities were contributed to the partnership, resulting in indirect gifts of the securities rather than direct gifts of limited partnership interests. The IRS based this on New York law that required the execution of a partnership agreement. However, New York law also provided that a "limited partnership is formed at the time of the filing of the initial certificate of limited partnership with the department of state or at any later time not to exceed sixty days from the date of filing specified in the certificate of limited partnership. The filing of the certificate shall, in the absence of actual fraud, be conclusive evidence of the formation of the limited partnership as of the time of filing or effective date, if later…."

Based on New York law, the Court was unable to reach a conclusion as to whether a limited partnership had been formed prior to December 15, 1998, when the limited partnership agreement was signed. Nonetheless, the Court determined that, in any event, under New York law, at least a general partnership had been formed on July 15, 1998 when Bianca and her daughters entered into the agreement to form the limited partnership and the certificate of limited partnership was filed. According to New York case law, when parties seeking to form a limited partnership do not satisfy the requirements necessary to form a limited partnership, they may be deemed to have formed a general partnership if their conduct indicates that they have agreed, whether orally and whether expressly or impliedly, on all essential terms and conditions of their partnership arrangement. The Court concluded that Bianca and her daughters had agreed upon the essential terms and conditions of their partnership arrangement just before the filing the certificate of limited partnership on July 15, 1998. Consequently, the transfers of securities, beginning in October and completed on December 4, had been to the partnership before December 15, 1998, the date on which the gifts were made.

The Court then rejected the indirect gift argument based on the fact that the transfers of the securities were reflected in Bianca's capital account before the gifts were made. In reaching this conclusion, the Court compared the facts in the instant case with the facts in *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001) and *Shepherd v. Commissioner*, 115 T.C. 376 (2000), *aff'd* 283 F. 3d 1258 (11th Cir. 2002). *Jones* involved gifts of limited partnership interests in two limited partnerships that were made on the same day that the limited partnerships were formed and funded. The Court rejected the IRS' indirect gift argument because the contributions to the partnership were credited to the capital account of the decedent before the gifts were made and the value of the capital accounts of the other partners were not enhanced by the contributions. In contrast, in *Shepherd*, the partnership agreement provided that any contributions would be allocated to the capital accounts of each partner according to ownership. Consequently, when Mr. Shepherd contributed real property and stock to the partnership in which his two sons held 25% interests, he made indirect gifts of the property and the stock rather than direct gifts of partnership interests.

Finally Judge Halpern rejected the step transaction argument advanced by the IRS. The step transaction doctrine embodies substance over form principles: it treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result. Where an interrelated series of steps are taken pursuant to a plan to achieve an intended result, the tax consequences are to be determined not by viewing each step in isolation, but by considering all of them as an integrated whole.

Judge Halpern had previously decided the *Holman* case, where he rejected the IRS' contention that the step transaction doctrine should apply to collapse transfers to the partnership and gifts made shortly thereafter so that the transfers to the partnership were indirect gifts. His decision was based on the fact that six days had elapsed from the date of the transfers of Dell stock to the partnership and the date the gifts of partnership interests were made. Because the Dell stock was publicly traded, Mr. Holman bore the economic risk that the stock would decrease in value during that period. In the instant case, Judge Halpern again concluded that, because 11 days had elapsed between the date of the last transfer of publicly traded securities to the partnership and the date the gifts of partnership interests were made, the step transaction doctrine did not apply under the facts in the instant case.

The Court held that the 35% discount, which had been stipulated by the parties if the transfers were of limited partnership interests, was still appropriate even though the transfers may have been of general partnership interests. This conclusion was based on the uncontradicted testimony of the taxpayer's expert that the daughters' interests under the agreement of July 15, 1998 were subject to the same restrictions that would have applied under the limited partnership agreement.

c. Analysis of the Court's Opinion

This case again points out the importance of complying with the formalities of state law. Had the limited partnership agreement been signed at the same time or soon after July 15, 1998, the IRS' position would have been greatly weakened. In addition, the gift tax return contained a schedule that stated that the shares had been transferred on December 15, giving the IRS another leg to stand on in its indirect gift argument. Fortunately for the taxpayer, the Court held that schedule was intended to be a list of the securities that had been previously contributed. Evidently, the IRS did not raise the possible application of I.R.C. § 2703 to disregard the restrictions that the Court found sufficient to justify the 35% discount.

Troubling is the Court's willingness to consider the step transaction doctrine in this case, which the IRS had also raised in *Senda v. Commissioner*, 433 F. 3d 1044 (8th Cir. 2006), *affg* T.C. Memo 2004-160, and *Holman*. Although, as in *Holman*, the Court did not find that the doctrine applied under the facts in the instant case, it did note, as it did in *Holman*, that its decision was based on the nature of the asset, and that a different asset, such a preferred stock or a long-term Government bond, might require a longer period between the contribution of the asset to the entity and gifts of interests in the entity to avoid collapsing the two transactions.

To avoid the indirect gift argument, it is imperative that contributions to the family business entity increase the capital accounts of the contributing owners, and that this is clearly documented in the entity's records, before the contributing owners make gifts of interests in the entity to others. To avoid the step transaction doctrine, it may be necessary to wait some period of time before the gifts are made. How long evidently depends upon the nature of the asset. Publicly traded common stock may require a period as short as six days, which Judge Halpern held was sufficient in *Holman*. The length of time for other assets may depend upon the volatility of the asset. However, the step transaction doctrine should not apply when the intent is to transfer interests in the entity, rather than interests in the underlying assets, for legitimate nontax reasons. It appears that the step transaction doctrine is the IRS' gift tax counterpart to its 2036(a) attack on family limited partnerships in the estate tax context. As in the 2036(a) cases, a legitimate and significant nontax reason for forming and funding the entity should go a long way to defeating a step transaction challenge.

7. ***Estate of Hurford v. Commissioner***, T.C. Memo 2008-278

a. Facts of the Case

Gary Hurford, who was a former president of Hunt Oil Company, died on April 8, 1999. Gary was survived by his wife, Thelma, and his three children: Michael, who was a psychiatrist practicing in Kentucky; David, who had personal problems and worked on one of the family ranches; and Michelle, who was the family's bookkeeper. The total assets owned by Gary and Thelma at Gary's death had an estate tax value of $14,246,784 and consisted of real estate, stock, bonds, mortgages, notes, cash, life insurance proceeds, miscellaneous property, and Hunt Oil Phantom Stock having a $5,552,377 value. His estate plan provided for the typical division into a bypass trust designed to pass estate-tax free at Thelma's death and a QTIP trust designed to qualify for the marital deduction. Thelma was diagnosed with cancer in early 2000.

Soon after Gary's death, the attorney who had done the family's estate planning was replaced by a more aggressive estate planning attorney. Michelle and Thelma took notes on nearly every meeting involving the estate planning after Gary's death. Michelle turned these notes over to the IRS. The Court noted that this was a strong indicator of her honesty. The new attorney advised Thelma to set up three limited partnerships to which she contributed substantially all her assets, including the assets that were supposedly in the bypass and QTIP trusts. The new attorney then advised Thelma to sell her interests in the three limited partnerships to her children in exchange for a private annuity. Because Thelma did not want David to have any signature authority with respect to the family's assets, both to protect him and the assets, the actual sale was to Michael and Michelle only. However, Thelma made it clear to Michael and Michelle that when she died, the assets remaining in the FLPs should be divided equally among all three of her children.

There were a number of problems with the documentation and implementation of the estate plan that the new attorney had recommended, including the use of incorrect values for the assets transferred by Thelma to the partnerships. In a number of places, Judge Holmes, who decided the case, referred to the attorney's work product as sloppy and poorly drafted. Thelma died on February 19, 2001. The assets reported on Thelma's estate tax return amounted to $846,666. The IRS issued two notices of deficiency in November 2004, one for the estate tax return for $9,805,082 and plus $1,956,066 in penalties; and one for the 2000 gift tax return for $8,314,283, plus $1,662857 in penalties. The notice of deficiency prompted by the gift tax return characterized the $14,981,722 Thelma transferred under the guise of the private annuity as gifts to Michael and Michelle because the annuity's real fair market value was $O.

b. Court's Opinion

The Court first dealt with the private annuity and then the FLPs. The first issue with regard to the private annuity was whether the transfer of Thelma's FLP interests in exchange for the private annuity was a bona fide exchange for adequate and full consideration. The attorney used the values reported on Gary's estate tax return for valuing the FLP interests Thelma transferred in exchange for the private annuity, which were lower than the values at the time of the transfers. In addition, the attorney determined the discounts for lack of control and lack of marketability on his own. Consequently, because the value of the annuity was less than the value of the FLP interests transferred in exchange, the exchange did not satisfy the bona fide exchange exception.

The next issue with regard to the private annuity was whether Thelma retained a prohibited interest in the property she transferred to her children through the private annuity. Thelma's annuity payments came from the FLPs and she directed Michael and Michelle as to how the assets were to be divided upon her death. Based on these facts, the Court found that Thelma retained an impermissible interest in the assets she had tried to transfer to her children through the private annuity.

The Court then turned to the FLPs. The first issue was whether the creation of the FLPs was bona fide sale for adequate and full consideration. Although the estate offered ten reasons for forming the partnerships, the estate mainly relied on two of them: asset protection and asset management. The Court found that placing the assets in the partnerships provided no greater protection than they had while held by the bypass and QTIP trusts and in Thelma's own name. The Court also did not find any advantage in consolidated management gained from the transfer, particularly because the partner's relationship to the assets did not change after the formation.

In addition the Court pointed to a number of factors that indicated the transfers to the partnerships were not motivated by a legitimate and significant nontax reason. These included Thelma's financial dependence on distributions from the partnerships, the commingling of personal and partnership funds, the delay or failure to transfer property to the partnerships, the taxpayer's old age or poor health, the lack of any business enterprise or meaningful economic activity, and the lack of adherence to partnership formalities. The Court concluded that the purpose in forming the FLPs was nothing more than obtaining a discount, and therefore, the transfers were not bona fide.

The next issue was whether Thelma retained the possession or enjoyment of, or the right to the income from the property she transferred to the FLPs. Because Thelma used the FLP assets to pay her personal expenses, transferred nearly all of her assets to the FLPs, and her relationship to the assets remained the same before and after the transfer, Thelma retained an interest in the transferred assets. The Court then considered Thelma's transfer of the FLP interests in exchange for the private annuity, which theoretically would have meant that she retained no FLP interests at her death. Because the transfers occurred within three years of Thelma's death, the transferred FLP interests would have been included in her estate under I.R.C. § 2035(a), even if the private annuity had been valid.

Unfortunately, the Court determined that, because the assets that were to be held in the bypass trust were withdrawn by Thelma, those assets were included in her estate, thereby causing a worse result than if no planning had been done after Gary's death. Finally, the Court determined that the negligence penalty did not apply to Michael as the executor of Thelma's estate. The Court found that Michael's reliance on the professionals he chose, however unsuitable they turned out to be, was nevertheless under the circumstances done reasonably and in good faith, and therefore it did not impose a penalty for negligence or disregard of the Code.

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

Because of the many poor facts for the taxpayer in this case, it is surprising that the Court spent so much time in rejecting the taxpayer's various contentions. However, the Court did provide a detailed analysis of the tests that determine whether I.R.C. § 2036(a) applies to either a transfer in exchange for a private annuity or a transfer to an FLP.

8. ***Estate of Jorgensen v. Commissioner***, T.C. Memo 2009-66

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

The decedent died on April 25, 2002. She owned limited partnership interests in two limited partnerships, one created while her husband was alive and the other created after his death. Both partnerships held only marketable securities, money market funds, and cash. At her death, her two children were the general partners of both partnerships as well her attorneys-in-fact. The decedent made gifts of limited partnership interests to her children and grandchildren. The IRS determined a $796,954 deficiency against the estate. The issues were (1) whether the values of the assets the decedent transferred to the two limited partnerships were included in the value of her gross estate under I.R.C. § 2036(a); and (2) whether the estate was entitled to equitable recoupment.

b. Court's Opinion

Because the Court decided the case based on the preponderance of the evidence, it did not determine whether the burden of proof had shifted to the government. The Court also determined that any voluntary inter vivos act of transferring property is a transfer for purposes of I.R.C. § 2036(a).

In determining whether the transaction qualified as a bona fide sale, the Court considered whether there were legitimate and significant nontax reasons for transferring her property to the partnerships. Based on the facts in the case, the Court rejected each of the estate's reasons, which included the following:

(1) *Management succession*, because there was no active management of investments;

(2) *Financial education of family members and promotion of family unity*, because there was no indication that there was any involvement of the children and grandchildren in the management of the partnership or the investment decisions and because the children had different spending habits, there was likely to be more family disunity than unity;

(3) P*erpetuation of the family's investment philosophy and motivating participation in the partnerships*, because there was no meaningful participation by the limited partners in the partnerships;

(4) *Pooling of assets*, because there was little evidence to support there were any economies of scale achieved by the partnerships;

(5) *Spendthrift concerns*, because there was no showing that the partnerships provided any protection from creditors; and

(6) *Providing for children and grandchildren equally*, because this objective could have been accomplished by giving the assets contributed to the partnerships to the children and grandchildren directly.

The Court also noted factors that indicated the transfers were not bona fide, which included tax savings as the primary reason for forming and funding the partnerships, the disregard of partnership formalities, and the fact that either the decedent's husband or the decedent stood on both sides of the transactions. The IRS conceded that the transfers were made for full and adequate consideration.

The Court then considered whether the decedent retained the possession or enjoyment of the transferred property. Because of the actual use of a substantial amount of partnership assets to pay the decedent's predeath and postdeath obligations, including making gifts of cash to her children and grandchildren, the Court concluded that there was an implied agreement at the time of the transfer of the decedent's assets to the partnerships that she would retain the economic benefits of the property even if the retained rights were not legally enforceable. In the alternative, the Court also found that, because the decedent's children as cotrustees of the decedent's trust were under a fiduciary obligation to administer the trust assets, including the partnership interests, solely for the decedent's benefit, and as general partners of the partnerships they had the express authority to administer the partnership assets at their discretion, the decedent retained the use, benefit, and enjoyment of the assets she transferred to the partnerships. Although the estate did not press the issue, the Court would not have found that the decedent terminated a portion of her interest in the partnerships when she gifted partnership interests to her children and grandchildren.

The final issue involved whether the estate tax deficiency could be offset by the income tax paid by the children and grandchildren on sales of stock by the partnerships after the decedent's death. The children and grandchildren used as the basis for the stock the fair market value of the stock as reported on the decedent's estate tax return. The basis would have been higher had the estate reported the value as determined by the IRS and subsequently by the Court. Although the children and grandchildren filed protective refund claims, the claim for at least one of the years was barred by the statute of limitations.

The doctrine of equitable recoupment allows a litigant to void the bar of an expired statutory limitation period if the following elements are shown: (1) the overpayment or deficiency for which recoupment is sought by way of offset is barred by an expired period of limitation; (2) the time-barred overpayment or deficiency arose out of the same transaction, item, or taxable event as the overpayment or deficiency before the Court; (3) the transaction, item, or taxable event has been inconsistently subjected to two taxes; and (4) if the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one. The Court found that all four elements were met in this case.

c. Analysis of the Court's Opinion

This case confirms the analysis of other FLP cases in favor of the government where the facts were similar; lack of conformity to formalities, little support for any legitimate and significant nontax reason for forming and transferring assets to the entity, and numerous factors indicating that the primary purpose in creating the entity was to obtain valuation discounts.

While some may argue that the taxpayer will never win when the only assets in the limited partnership are marketable securities, if the family can truly establish that there were one or more legitimate and significant nontax reasons for forming and funding the limited partnership, and the proper formalities are observed, under current law the transferred interests should still be valued taking into account appropriate discounts for lack of control and lack of marketability under the willing buyer/willing seller standard. Had the family in this case substantiated the nontax reasons that the Court considered and rejected, and had they abided by the formalities, including making only pro rata distributions from the partnerships, the result may have been different. In addition, the advisors in this case emphasized in letters to the family the discounts that would be obtained if they formed and funded the partnerships. While saving taxes is not a bad motive for forming and funding a family limited partnership, it should not be the only or even the primary reason.

APPENDIX: FLPs AFTER *MIROWSKI*

A. The Benefits of Using FLPs and FLLCs

1. Transfer Tax Benefits.

a. Discounts.

(1) Lack of Control.

(2) Lack of marketability.

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

b. Example.

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

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

2. Nontax benefits.

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

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

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

d. Greater diversification.

e. Lower investment and management costs.

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

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

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

i. Educate younger family members concerning investments.

j. Avoid ancillary administration and possibly state inheritance taxes.

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

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

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

n. Maintain the older family members' investment philosophy.

B. IRS Response

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

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

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

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

1. Sham transaction.

2. Step transaction.

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

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

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

6. Gift on formation.

7. Challenge the amount of discount.

D. Courts Reject IRS Challenges

1. Validly formed entity cannot be disregarded.

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

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

4. Restrictions on the right to withdraw and receive some value for the interest of the withdrawn owner were not applicable restrictions under I.R.C. § 2704(b).

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

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

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

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

E. IRS Finds New Arrows in its Quiver

1. I.R.C. § 2036(a) reads as follows:

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

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

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

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

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

4. Eighteen cases have held that the decedent, in connection with transfers of property to an FLP, had retained the right to the income from the transferred assets under an implied agreement, based on the facts in the cases. *Estate of Schauerhamer v. Commissioner*, T.C. Memo 1997-242; *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000); *Estate of Harper v. Commissioner*, T.C. Memo 2002-121; *Estate of Thompson v. Commissioner*, T.C. Memo 2002-246, *aff'd*, *Turner v. Commissioner*, 3d Cir., No. 03-3173, September 1, 2004; *Kimbell v. United States*, 2003-1 USTC ¶ 60,455 (N.D. Tex. 2002); *Estate of Strangi v. Commissioner*, No. 03-60992 (5th Cir. July 15, 2005), *aff'g* T.C. Memo 2003-145 (*Strangi*, *II*); *Estate of Ida Abraham v. Commissioner*, 95 AFTR 2d 2005-2591 (lst Cir. May 25, 2005), *aff'g* T.C. Memo 2004-39 (February 18, 2004); *Estate of Lea K. Hillgren*, T.C. Memo, 2004-46; *Estate of Bongard v. Commissioner*, 124 T.C. No. 8 (March 15, 2005); *Estate of Bigelow v. Commissioner*, T.C. Memo 2005-65 (March 30, 2005), *aff'd*, 100 AFTR 2d 2007-6016 (9th Cir. September 14, 2007); *Estate of Edna Korby v. Commissioner*, T.C. Memo. 2005-102 (May 10, 2005); *Estate of Austin Korby v. Commissioner*, T.C. Memo 2005-103 (May 10, 2005); *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115; *Estate of Erickson v. Commissioner*, T.C. Memo, 2007-107; *Estate of Sylvia Gore, et al. v. Commissioner*, T.C. Memo 2007-169; *Estate of Rector*, T.C. Memo 2007-367; *Estate of Hurford v. Commissioner*, T.C. Memo

2008-278; and *Estate of Jorgensen v. Commissioner,* T.C. Memo 2009-66..

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

5. Two of these cases also held that the decedent had retained the right to designate the persons who would possess or enjoy the transferred property or income from the transferred property. *Kimbell v. United States*, 2003-1 USTC ¶ 60,455 (N.D. Tex. 2002) and *Estate of Strangi v. Commissioner*, T.C. Memo 2003-145 (*Strangi*, *II*).

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

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

c. The Fifth Circuit, in affirming *Strangi II*, did not deal with the I.R.C. § 2036(a)(2) issue because it found that I.R.C. § 2036(a)(1) applied.

6. Five cases, *Estate of Schutt v. Commissioner*, T.C. Memo. 2005-126 (May 26, 2005); *Estate of Bongard v. Commissioner*, 124 T.C. No. 8 (March 15, 2005); *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004); *Estate of Stone v. Commissioner*, T.C. Memo 2003-309, *Estate of Mirowski*, T.C. Memo 2008-74, have held that I.R.C. § 2036(a) did not apply because of the bona fide sale exception.

a. Seventeen of the eighteen cases involving 2036(a) have held that the exception did not apply, based on a two-prong analysis:

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

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

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

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

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

e. In *Mirowski*, Judge Chiechi concluded that, because Ms. Mirowski received an interest in MFV proportionately equal to the fair market value of her contribution (which in this case was 100%) and there were three legitimate and significant nontax reasons for forming and funding MFV, the bona fide sale exception applied.

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

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

F. Where Do We Stand Today

1. In light of *Strangi II*, *Schutt*, *Bongard*, *Turner/Thompson*, *Kimbell*, and *Mirowski*, FLPs and FLLCs that are properly structured and

operated should continue to provide an efficient means of transferring wealth to younger generations; however, it is important to have either a business purpose or a legitimate and substantial nontax purpose for creating the entity if the bona fide sale exception is needed because either I.R.C. § 2036(a)(1) or § 2036(a)(2), or both, apply.

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

b. See also the discussion of the *Mirowski* case, in which the decedent transferred patent rights and marketable securities worth well over $60 million to an LLC days before she died, and yet the IRS was unsuccessful in applying either I.R.C. § 2036(a)(1) or § 2036(a)(2).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

G. Proposed Legislation

1. OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, prepared by the Staff of the joint Committee on Taxation, published January 27, 2005, in response to a request by Senators Grassley and Baucus, the then Chairman and the ranking Member of the Senate Finance Committee (hereinafter the Report) (the Report can be accessed at http://www.house.gov/jct/s-2-05.pdf), sets forth the following set of rules for valuing property for federal transfer tax purposes that would limit the availability of minority and lack of marketability discounts and would apply to shares of stock of a corporation, interests in a partnership or limited liability company, and other similar interests in a business or investment entity or in an asset.

   a. The proposal has two parts, aggregation rules and a look-through rule.

   b. Step transaction principles are used to determine whether two or more transfers are treated as a single transfer and an interest owned by the spouse of a transferor or transferee is considered as owned by the transferor or transferee.

   c. The rules generally apply to all gifts made during life without consideration, transfers at death, generationskipping events, and any transfer of an asset by gift for an amount of consideration less than the value determined under those rules.

(1) The rules are not intended to change the principles of present law concerning whether transfers made in the ordinary course of business are, or are not, treated as gifts.

d. Under the basic aggregation rule, the value of an asset transferred by a transferor (a donor or decedent) generally is a pro rata share of the fair market value of the entire interest in the asset owned by the transferor just before the transfer.

(1) For example, if mother, who owns 80% of the interests in a limited liability company, transfers a 20% interest to a child, the value of the 20% interest would be 25% of the value of the mother's 80% interest, with no minority discount.

(2) If mother only owned a 40% interest, the 20% interest transferred to the child would reflect the minority discount applicable to mother's 40% interest.

e. Under the transferee aggregation rule, if a donor or a decedent's estate does not own a controlling interest in an asset just before the transfer of all or a portion of the asset to a donee or heir, but, in the hands of the donee or heir, the asset is part of a controlling interest, the value of the asset is a pro rata share of the fair market value of the entire interest in the asset owned by the donee or heir after taking into account the gift or bequest.

(1) In the second example above, if the child already owned a 40% interest before mother's gift of the 20% interest, the value of the gifted interest would be one-third of a 60% interest, resulting in no minority discount.

f. Under the look-through rule, after the application of the aggregation rules, if a transferred interest in an entity is part of controlling interest owned before the transfer by the transferor, or after the transfer by the transferee, then, if at least one-third of the value of the entity's assets consists of marketable assets, the value of the marketable assets is determined without taking into account any marketability discount.

(1) Marketable assets include cash, bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. and foreign treasury obligations and bonds, precious metals or commodities, and publicly traded instruments, but do not include assets that are part of an active lending or financing business.

2. **The following is part of H.R. 436, introduced by Democratic Representative Earl Pomeroy on January 9, 2009.**

Sec. 4. VALUATION RULES FOR CERTAIN TRANSFERS OF NONBUSINESS ASSETS; LIMITATION ON MINORITY DISCOUNTS.

(a) In General. Section 2031 of the Internal Revenue Code of 1986 (relating to definition of gross estate) is amended by redesignating subsection (d) as subsection (f) and by inserting after subsection (c) the following new subsections:

"(d) Valuation Rules for Certain Transfers of Nonbusiness Assets- For purposes of this chapter and chapter 12—

"(1) IN GENERAL- In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092)—

"(A) the value of any nonbusiness assets held by the entity shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets), and

"(B) the nonbusiness assets shall not be taken into account in determining the value of the interest in the entity.

"(2) NONBUSINESS ASSETS- For purposes of this subsection—

"(A) IN GENERAL- The term "nonbusiness asset" means any asset which is not used in the active conduct of 1 or more trades or businesses.

"(B) EXCEPTION FOR CERTAIN PASSIVE ASSETS- Except as provided in subparagraph (C), a passive asset shall not be treated for purposes of subparagraph (A) as used in the active conduct of a trade or business unless—

"(i) the asset is property described in paragraph (1) or (4) of section 1221(a) or is a hedge with respect to such property, or “(ii) the asset is real property used in the active conduct of 1 or more real property trades or businesses (within the meaning of section 469(c)(7)(C)) in which the transferor materially participates and with respect to which the transferor meets the requirements of section 469(c)(7)(B)(ii).

For purposes of clause (ii), material participation shall be determined under the rules of section 469(h), except that section 469(h)(3) shall be applied without regard to the limitation to farming activity.

“(C) EXCEPTION FOR WORKING CAPITAL- Any asset (including a passive asset) which is held as a part of the reasonably required working capital needs of a trade or business shall be treated as used in the active conduct of a trade or business.

“(3) PASSIVE ASSET- For purposes of this subsection, the term ”passive asset“ means any—

“(A) cash or cash equivalents,

“(B) except to the extent provided by the Secretary, stock in a corporation or any other equity, profits, or capital interest in any entity,

“(C) evidence of indebtedness, option, forward or futures contract, notional principal contract, or derivative,

“(D) asset described in clause (iii), (iv), or (v) of section 351(e)(1)(B),

“(E) annuity,

“(F) real property used in 1 or more real property trades or businesses (as defined in section 469(c)(7)(C)),

“(G) asset (other than a patent, trademark, or copyright) which produces royalty income,

“(H) commodity,

“(I) collectible (within the meaning of section 401(m)), or

“(J) any other asset specified in regulations prescribed by the Secretary.

“(4) LOOK-THRU RULES—

“(A) IN GENERAL- If a nonbusiness asset of an entity consists of a 10-percent interest in any other entity, this subsection shall be applied by disregarding the 10-percent interest and by treating the entity as holding directly its ratable share of the assets of the other entity. This subparagraph shall be applied successively to any 10-percent interest of such other entity in any other entity.

“(B) 10-percent INTEREST- The term ”10-percent interest“ means—

“(i) in the case of an interest in a corporation, ownership of at least 10 percent (by vote or value) of the stock in such corporation,

“(ii) in the case of an interest in a partnership, ownership of at least 10 percent of the capital or profits interest in the partnership, and "(iii) in any other case, ownership of at least 10 percent of the beneficial interests in the entity.

"(5) COORDINATION WITH SUBSECTION (b)- Subsection (b) shall apply after the application of this subsection.

"(e) Limitation on Minority Discounts- For purposes of this chapter and chapter 12, in the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092), no discount shall be allowed by reason of the fact that the transferee does not have control of such entity if the transferee and members of the family (as defined in section 2032A(e)(2)) of the transferee have control of such entity.".

(b) Effective Date. The amendments made by this section shall apply to transfers after the date of the enactment of this Act.

3. **The following is an excerpt from the Green Book describing the Obama Administration's Tax Proposals, issued by the Treasury Department on May 11, 2009.**

MODIFY RULES ON VALUATION DISCOUNTS

Current Law

The fair market value of property transferred, whether on the death or during the life of the transferor, generally is subject to estate or gift tax at the time of the transfer. Sections 2701 through 2704 of the Internal Revenue Code were enacted to prevent the reduction of taxes through the use of "estate freezes" and other techniques designed to reduce the value of the transferor's taxable estate and discount the value of the taxable transfer to the beneficiaries of the transferor when the economic benefit to the beneficiaries is not reduced by these techniques. Generally, section 2704(b) provides that certain "applicable restrictions" (that would normally justify discounts in the value of the interests transferred) are to be ignored in valuing interests in family-controlled entities if those interests are transferred (either by gift or on death) to or for the benefit of other family members. The application of these special rules results in an increase in the transfer tax value of those interests above the price that a hypothetical willing buyer would pay a willing seller, because section 2704(b) generally directs an appraiser to ignore the rights and restrictions that would otherwise support significant discounts for lack of marketability and control.

Reasons for Change

Judicial decisions and the enactment of new statutes in most states have, in effect, made section 2704(b) inapplicable in many situations, specifically, by recharacterizing restrictions such that they no longer fall within the definition of an "applicable restriction". In addition, the Internal Revenue Service has identified additional arrangements designed to circumvent the application of section 2704.

Proposal

This proposal would create an additional category of restrictions ("disregarded restrictions") that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transfer's family. Specifically, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard identified in regulations. A disregarded restriction also would include any limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family. Regulatory authority would be granted, including the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met. This proposal would make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions.

This proposal would apply to transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of section 2704).

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