APPLYING VALUATION DISCOUNTS TO WEALTH TRANSFER TECHNIQUES

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Applying Valuation Discounts To Wealth Transfer Techniques[1]

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§ 1.1 INTRODUCTION

[1] Estate Planning Objectives

Two primary objectives of estate planning are to preserve the estate and facilitate transfer of wealth from one generation to the next with the least possible transfer cost. This type of planning takes many forms, but in recent history it involves the removal of assets from the estate and/or a manipulation of value through the use of various discounting techniques. Other objectives such as income tax planning and disposition planning often times may be more important but are obscured by an individual's drive to lower taxes by the transfer of wealth. A plan which lowers the estate taxes but disposes the estate to the wrong people in the wrong manner is not a good one. Nevertheless, these objectives are not dealt with in this outline. This paper will outline the basic rules of valuation and then apply these rules to various advanced transfer techniques.

For example, using a limited partnership or a limited liability company (LLC) to transfer wealth to younger family members can accomplish a substantial reduction in the value for

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transfer tax purposes of the transferred assets because of valuation discounts for lack of control and lack of marketability. Thus, if an older family member desires to transfer to a younger family member 25% of his or her actively traded Fortune 500 Company stock worth $1,000,000, a direct transfer of the shares to the younger family member or to a trust for his or her benefit would be a taxable gift of $250,000. If, however, the donor transfers the $1,000,000 worth of traded stock to an LLC and receives all the LLC interests in exchange and then gives a 25% interest in the LLC to the younger family member, the value of the gift for gift tax purposes may be substantially less than $250,000. The value will depend on the lack-of-control and lack-of-marketability discounts a business appraiser would attribute to a 25% interest in an LLC owning the traded stock worth $1,000,000.

A lack-of-control discount, also known as a minority interest discount, is appropriate when valuing an interest in an entity that does not give the holder of the interest the right to decide when distributions of earnings will be made (lack of voting or management rights), when the entity will be liquidated or when the holder's interest will be redeemed, and other issues that affect the financial benefits of ownership in the entity, such as restrictions on the holder's rights to transfer ownership to a third person. A lack-of-marketability discount is appropriate when valuing an interest in an entity for which there is no active trading market and takes account of the fact that such an interest will be more difficult to sell and may also require the expenditure of funds to do so, such as legal, accounting and syndication fees.

[2] Burden of Taxes

The federal estate tax is imposed on the taxable estate.[4] IRC Section 2501 defines the taxable estate as the gross estate less various deductions. The gross estate is everything owned by a decedent at his death.[5] Gifts made within three years of death are not included within the taxable estate with a few exceptions.[6] However, gift tax paid within three years is added back into the estate.[7] This outline is not intended to discuss the tax system in detail (which may create other ways of reducing the tax burden).

[3] Valuation Techniques

As a general rule, it is desirable to transfer an asset that is not easily transferable or to transfer it in incremental stages in order to take advantage of reduced values through valuation discounts and liquidation rights[8]. Such discounts are discussed in detail below and their applicability to traditional sophisticated estate planning techniques used in the transfer of wealth.

§ 1.2 THE BASIC RULES OF VALUATION

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[4] IRC Section 2001.

[5] IRC Sections 2031-2044.

[6] For example, transfers of property under IRC Sections 2036, 2037, 2038 or 2042.

[7] IRC Section 2039(c).

[8] Form 709, the federal gift tax return, now requires disclosure of whether a valuation discount has been applied and substantiation for the discount.

Taxpayers may make gifts during their lifetime or at death. The gifts made at death are referred to in this Article as "bequests." Both lifetime gifts and bequests are valued for the purposes of calculating the gift or estate tax payable.[9] Property is valued using a hypothetical situation of an arm's-length transaction between a willing buyer and a willing seller, neither of whom is acting under a compulsion to buy or sell, and each of whom has reasonable knowledge of all relevant facts.[10] This formula has been described by some cynics as the price which would be paid for your business by a greedy lawyer and a zealous IRS agent, neither of whom have had any business experience.

[1] Gift Tax Rules

The gift tax Regulations elaborate on the formula as follows:

> "The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measurement of enrichment resulting to the donee from the transfer, nor is it conditioned upon the ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable."[11]

The Regulations go on to state that the fair market value of an item will contain the following characteristics:

- This is not the forced sale price.[12]
- This is not the sale price of the item in a market other than that in which the item is most commonly sold to the public, taking into account the location of the item when appropriate.[13]

[2] Gift Tax Regulations

The gift tax Regulations provide that the net value will be determined on the basis of all relevant factors including:

"(1) A fair appraisal as of the date of the gift of all the assets of the business, tangible and intangible, including goodwill;

(2) The demonstrated earning capacity of the business; and

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9 IRC §§ 2033(a), 2512(a).

10 Treas. Regulations §§ 20.2031-1(b), 20.2031-3, 25.2512-1, *United States v. Cartwright*, 411 U.S. 546 (1973).

11 Treas. Regulation § 25.2511-2(a).

12 Treas. Regulation § 20.2031-1(b).

13 Treas. Regulation § 20.2031-1(b).

(3) The other factors set forth in paragraph (f) of § 25.2512-2 relating to the valuation of corporate stock, to the extent applicable."[14]

In the estate tax arena, if the wealth of the donor decreases but the wealth of the transferee does not increase, there is no tax. This appears clearly in the cemetery plot example in Regulation § 20.2033-1(b). The same reasoning should apply for gifts.

[3] Difference In Rules

There is a fundamental difference between the rules relating to estate taxes and the rules relating to gift taxes. For example, the gift tax is not tax inclusive (there is no tax on the tax unless the donor dies within three years of the gift) and the estate tax is tax inclusive. In the estate tax area, the assets in the estate are valued without regard to the number of heirs or the interest they already own.[15] On the other hand, the gift tax is imposed on property passing from the donor to *each* donee.[16] If the donor makes several gifts, each is valued separately. The impact on the donor is not relevant. The value received by the donee is not relevant. (In fact, as stated above, the identity of the donee need not be established.) These differences bestow a significant benefit on taxpayers who make gifts. For example, a $300,000 bequest to three children of a property would not establish a discount, yet three gifts to the children may create a substantial discount.

In a 1989 Technical Advice Memorandum[17] (TAM), the IRS purported to deal with the situation where a taxpayer makes a series of gifts in the corporation to the same donee. If the third gift reduced the taxpayer's holding below 50%, this should be valued at a premium (said the IRS). This issue was not specifically addressed by Revenue Ruling 93-12, discussed below. However, it would appear that the TAM is at odds with this Revenue Ruling.

§ 1.3 ARGUMENTS RAISED BY THE IRS

The IRS has raised a large number of arguments in an attempt to reduce, limit or obliterate discounts. The IRS does not like discounts arising out of family limited partnerships. The issue is an Appeals Coordinated Issue.[18] Most of these arguments have failed but the IRS continues to use them to reduce discounts during settlement discussions. What follows is a discussion of these arguments.

[1] Unity of Ownership

The traditional approach of the IRS has been to dispute the approach to valuation where the parties are family members unless, of course, there is evidence of a family dispute. This approach was set out by the IRS in an early Revenue Ruling which for many years reflected the

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14 Treas. Regulation § 25.2512-2(a).

15 *Estate of Curry v. United States*, 706 F.2d 1424 (7th Cir. 1983); *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981); *Chenoweth v. Commissioner*, 88 T.C. 1577 (1987).

16 See TAM 9449001 (March 11, 1994) and TAM 9436005 (May 26, 1994).

17 TAM 8907002 (Nov. 1, 1988).

18 Internal Revenue Service Manual ¶ 8.7.1.7.12.4 (Sept. 28, 1999).

IRS's position.[19] Also, there are several cases which have given some credence to the IRS approach.[20] However, in the bulk of the cases supporting family "attribution", there is evidence of family members acting in concert. In fact, in the vast majority of the cases, the IRS has consistently been knocked back by the courts (unless there was evidence of family members acting in concert).

It is interesting to note that in 1984 the IRS sought to have the law changed (without success) to the effect that minority or fractional-share discounts be eliminated where the donor retained an interest in the subject property after the gift and where the donor had previously made a gift of a fractional interest in that property.[21] This proposal may have been the precursor to the current position taken by Congress in Chapter 14 of the Code,[22] which is discussed elsewhere in this outline.

In 1987, Congress again considered a statutory provision disallowing minority interest discounts, this time when a family controlled the business. Ultimately, I.R.C. § 2036(c) was enacted instead, causing the value of a decedent's gross estate to include the value of property transferred during life by the decedent holding a substantial interest in an enterprise, if such transfer represented a disproportionate share of the potential appreciation in the enterprise.[23] This anti-estate valuation freeze statute was subsequently replaced in 1990 by the special valuation rules of Chapter 14 of the code[24]. Although the initial proposal did not pass, the fact that Congress thought a statutory fix was necessary to eliminate minority discounts in family-controlled entities is, essentially, an expression of Congress' view that, without such a statutory provision, minority interest discounts would otherwise be appropriate in family-controlled entities.

The government's attack on minority and marketability discounts continues on the legislative front. The Clinton administration's tax proposals for the last three fiscal years have included a provision that would deny valuation discounts for interests in a family-controlled entity for transfer tax purposes to the extent that the entity held passive investments.[25]

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[19] Rev. Rul. 81-253, 1981-2 C.B. 187.

[20] See, e.g., *Driver v. United States*, 76-2 U.S.T.C. ¶ 13,155 (D. Wis. 1976); *Blanchard v. United States*, 291 F. Supp. 348 (D. Iowa 1968).

[21] *Tax Reform for Fairness, Simplicity and Economic Growth*, General Explanation of the Treasury Department Proposals, Chapter 19.03, Volume 2, Pages 386-388 (November 1984).

[22] (I.R.C. §§ 2701-2704), Pub. L. No. 101-508, tit. XI, §§ 11,601-11,602, 104 Stat. 1388-490 (1990).

[23] H.R. Rep. No. 100-391, at 661, enacted by Pub. L. No. 100-203, tit. X, § 10,402(a), 101 Stat. 1330-431 (1987).

[24] *See* H.R. Rep. No. 100-391, at 657 (1987), reprinted in 1987 U.S.C.C.A.N. 2313-378.

[25] *See, e.g.*, the Green Book, Feb. 1998, Department of the Treasury, p. 129; also found in General Explanation of the Administration's Revenue Proposals, Doc. 98-4793 Tax Notes Today 183 (Feb. 3, 1998).

[a] *Revenue Ruling 93-12*

Until the IRS issued Rev. Rul. 93-12[26] in 1993, it had taken the position that a lack-of-control or minority interest discount was not appropriate in valuing an interest in an entity controlled by a family. The courts rejected this position, which was originally set out in Rev. Rul. 81-253, 1981-2 C.B. 187, when challenged by taxpayers.[27]

Rev. Rul. 93-12 involved gifts by a 100% shareholder of a corporation of 20% of his stock to each of his five children. The IRS ruled that the family's control of the entity would not be considered in valuing the 20% interests. The IRS specifically revoked Revenue Ruling 81-253 (referred to above). Referring to earlier cases with approval, the IRS stated as follows:

> "If a donor transfers shares in a corporation to each of the donor's children, the factor of corporate control in the family is not considered in valuing each transferred interest for purposes of Section 2512 of the Code. For estate and gift tax valuation purposes, the service will follow *Bright*, *Propstra*, *Andrews*, and *Lee* in not assuming that all voting power held by family members may be aggregated for purposes of determining whether the transferred shares should be valued as part of a controlling interest. Consequently a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest. This would be the case whether the donor held 100 percent or some lesser percentage of the stock immediately before the gift."

This revenue ruling is also noteworthy for what it did not tell us. It did not tell us how the discount was to be calculated. It did not discuss the situation where the donor made five gifts to the same donee over five consecutive years. After Rev. Rul. 93-12 was issued, the estate planning profession was quick to spread the word.[28]

The IRS, in 1994, took back a bit of Rev. Rul. 93-12 when it ruled in a technical advice memorandum ("TAM") that a swing-vote premium was applicable when valuing a block of stock transferred to a family member if the block of stock enabled the transferee to join with another related owner of an interest in the entity to form a majority interest.[29] In the TAM, the sole shareholder/taxpayer had transferred a 30% block of stock to each of three children, so that any two of the children could combine to form a majority interest. The ruling was based on *Estate of*

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26 1993-1 C.B. 202.

27 *See, e.g., Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982); Est. of Bright v. U.S., 658 F.2d 999 (5th Cir. 1981); Est. of Andrews v. Comr., 79 T.C. 938 (1982); Est. of Lee v. Comr.*, 69 T.C. 860 (1978), *nonacq.*, 1980-2 C.B. 2

28 *See, e.g.,* S. Stacy Eastland, *Family Limited Partnerships: Transfer Tax Benefits*, 7 Prob. & Prop. 59 (1993); Alan S. Gassman and Matthew J. Schirmer, *Real Estate Tax Planning Tips After the Revenue Reconciliation Act of 1993*, 39-8 Prac. Law. 17 (1993); John R. Jones, Jr., *Family Limited Partnerships Achieve Tax and Nontax Goals*, 53 Tax'n for Accountants 33 (1994); Melcher Foot, *How to Quantify the Tax Benefits of Investment Family Limited Partnerships,* The Practical Tax Lawyer (Winter 1998); Frank J. Cavaliere and Howell Lynch*, the Looming Showdown over FLP Valuations for Transfer Tax Purposes*, the Practical Tax Lawyer (Winter 1999).

29 TAM 9436005 (May 26, 1994).

Winkler v. Comr.,[30] in which the Tax Court found that a 10% block of voting stock had special characteristics that enhanced its value when 40% of the stock was owned by the transferor's family and 50% by members of another family. See the further discussion on swing-vote premiums, below.

[b] *Beware of "Bad Facts" Cases*

While Rev. Rul. 93-12 appears to be the end of the unity of ownership concept, cynics have argued that the IRS may have issued this ruling in an attempt to get the Legislature to change the law. Pending legislation, this ruling has, to some extent, opened the flood gates on family discounting. Presumably the IRS will continue to litigate all bad facts cases, using principles like the step-transaction and substance over form doctrines. As indicated elsewhere in the article, it remains to be seen whether the IRS can successfully employ Chapter 14 of the Code to successfully fight discounts. In any event, the battle as to the size of the discount will continue and this is discussed in greater detail below.

Beginning in 1997, the IRS began to challenge lack-of-control and lack-of-marketability discounts in situations involving transfers just before the transferor died, particularly where the transfers were carried out by persons acting in a fiduciary capacity on behalf of the transferor. A review of seven TAMs issued in 1997 and 1998 indicates that the IRS has chosen to focus on situations involving at least one of the following three factors: (i) liquid assets, such as marketable securities, were transferred to a limited partnership or LLC; (ii) the transferor was elderly; or (iii) the transfer was carried out by third parties (such as children) as agents under a power of attorney or as trustees. [31]

In each TAM, the IRS asserted that the transaction should be treated as a single testamentary transaction and therefore *disregarded* for transfer tax purposes, relying in each case on the Tax Court case of *Estate of Murphy v. Commissioner*, in which the Court held that a minority interest discount was not applicable to stock of a closely held corporation owned by the decedent although the decedent owned slightly less than 50% of the stock at her death.[32] In *Murphy*, at the urging of her accountant, Mrs. Murphy had transferred a 1.76% interest to her children 18 days before her death specifically to reduce her interest below 50%. In each TAM the IRS quoted the Court's statement that "[a] minority discount should not be applied if the explicit purpose and effect of fragmenting the control block of stock was solely to reduce Federal tax."[33]

In *Murphy*, the Court concluded that the two gifts made by the decedent shortly prior to her death which reduced her interest below the 50% percent mark did not affect her beneficial interest except to reduce her federal estate taxes. In short, nothing changed except the taxes were

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30 T.C.M. 1989-231.

31 *See Est. of Schauerhamer v. Comr.*, 73 T.C.M. (CCH) 2855, T.C.M. 1997-242; *see also* TAM 9842003 (July 2, 1998); TAM 9736004 (June 6, 1997); TAM 9735003 (May 8, 1997); TAM 9730004 (Apr. 3, 1997); TAM 9725002 (Mar. 3, 1997); TAM 9723009 (Feb. 24, 1997); TAM 9719006 (Jan 14, 1997).

32 T.C.M. 1990-472.

33 T.C.M. 1990-472, citing *Knetch v. U.S.*, 364 U.S. 361, 367 (1960), *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

reduced. The Court sought to distinguish the cases supporting minority interest discounts on the following basis:

[i] The transferor in those cases did not have control prior to the transfers;

[ii] The parties in those cases had agreed that a minority discount was applicable;

[iii] Tax-motivated transactions were not found in those cases; or

[iv] The transaction in those cases preceded the estate tax unification in 1976.

Although the Court denied that it was applying a family attribution theory to reach its result, this denial seems to contradict the reasoning of the Court in reaching its conclusions. In making the denial, the Court stated as follows:

> "Attribution is treating stock owned by different persons as if it were owned by one person. It is not necessary to use attribution here because here the transfer of control to decedent's children in two steps in substance is one transaction. Using this analysis, decedent is subject to transfer tax on the control premium without attribution from family members. Accordingly, the Court does not apply a family attribution theory."

The Court applied the step-transaction doctrine, treating the transfer at death and the transfer during life (*shortly before death*) as one transfer. This has lead many commentators to conclude that the decision in *Murphy* should be confined to the unhappy facts. The *Murphy* case has become an important factor that the Service has used in its string of recent TAMs discussed above.

The *Murphy* case stresses the importance of timing and having a business purpose to the overall estate planning process of discounting. An obvious backdrop to the gift process may be the advancement of the children's involvement in the business. If the children are taking control of the business in substance (which was not the case in *Murphy*), then there will be an objective basis to justify the discount and avoid arguments like the step-transaction doctrine or sham which have their origin in the seminal case of *Gregory v. Helvering*.[34]

Not surprisingly, in all the TAMs except the last TAM issued in 1998, the IRS did not refer to *Estate of Frank v. Commissioner*, in which the Tax Court, on facts similar to *Murphy*, held that a transfer of stock two days before the decedent's death by his son, acting under a power of attorney, to the decedent's spouse, who died soon after the decedent, which reduced the decedent's ownership interest from just over 50% of the corporation to 32%, was valid for transfer tax purposes, resulting in an overall 45% combined discount for lack of marketability and lack of control.[35] The Court in *Frank* ignored the discount motive for the transfer because the tax avoidance result could have been achieved with a transfer of a substantially smaller amount of shares if tax avoidance were the sole motive.

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[34] 293 U.S. 465 (1935).

[35] T.C.M. 1995-12.

Perhaps the facts in *Frank* can be distinguished from the facts in *Murphy*. While in *Frank* there were no letters or other written evidence that the purpose of the transfer was to achieve a minority discount and a significant block of stock was transferred, in *Murphy* there were a number of letters from the family accountant urging Mrs. Murphy to make the transfers in order to obtain a minority interest discount at her death, and the amount of stock transferred was small.

An explanation for the difference in the amounts transferred in the *Frank* and *Murphy* is that in the former, the transfer between spouses would not be taxable under I.R.C. § 2523 and, upon the wife's death (she was also terminally ill), the children would receive a step-up in basis in the stock. In *Murphy*, on the other hand, the decedent did not have a spouse at the time of the transfer, and stock gifted to the children would have a carryover basis, so it was better from an income tax standpoint not to give the children any more stock than necessary to reduce her interest below 50%.[36]

In *Griffin v. U.S.*,[37] a District Court upheld the IRS's position that a husband's transfer of 45% of the stock of a corporation to his wife followed by a transfer by the wife of the stock to a trust for the benefit of their child and a transfer by the husband of another 45% of the stock of the same corporation to the same trust, would be disregarded, so that a minority interest discount was not appropriate in valuing the 90% block of stock ultimately received by the trust, based on substance over form. In doing so, the Court distinguished the *Frank* case from the *Murphy* case, based on the existence of a blatant appearance of a tax avoidance motive in *Murphy*, rather than the size of the block of stock transferred.

The IRS's second, alternative argument in support of its position in the TAMs, which also would disregard the entity for transfer tax purposes, is based on I.R.C. § 2703(a)(2). The IRS viewed I.R.C. § 2703 as applying to the entity itself, and not just to restrictions in an agreement or other document affecting an interest in the entity. Thus, the IRS treated the formation of the entity and the transfer of the interests in the entity at death as a single integrated transaction. The IRS concluded that a transfer of an interest in the entity would be treated as a transfer of a fractional interest in the underlying assets held by the entity. According to the Service, because the transfer became a transfer of the marketable securities themselves rather than an interest in the entity holding the securities, the a discount from the fair market value of the marketable securities would not be appropriate. Consistently, when applied to real estate, because the transfer became a transfer of an undivided interest in the real estate, a fractionalization discount would be appropriate.

The IRS argued that in the event its position that the entity itself should be disregarded were to be deemed by the courts an incorrect reading of I.R.C. § 2703, any restrictions on the right to transfer an interest in the entity or to liquidate an interest in the entity should be disregarded under I.R.C. § 2703 because the restrictions were a device to transfer the interest to the objects of the decedent's bounty for less than full and adequate consideration in money or

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[36] *See* Louis A. Mezzullo, *Valuation Issues Involving Family Limited Partnerships and Family Limited Liability Companies: Recent Developments* (April 20, 2000).

[37] (W.D. Tex 1998), No. A96-CA-96055.

money's worth. In other words, the restrictions did not satisfy the I.R.C. § 2703(b) exception to the general rule under I.R.C. § 2703(a) that the value of an interest in a partnership or corporation be determined without regard to such restrictions.

Also, in all but one of the TAMs, the IRS contended, as its third, alternative position, that, under I.R.C. § 2704(b), any limitations on the right to liquidate the interests that were more restrictive than the state's default rule should be disregarded. The IRS rejected the taxpayer's position that I.R.C. § 2704(b) only applies to a right to liquidate the entire entity. Note, however, that in *Kerr v. Commissioner*,[38] Judge Jacobs held that an applicable restriction that must be disregarded under I.R.C. § 2704(b) if it is more restrictive than state law is a restriction on the right to have the entity liquidated and not on the right to have an interest in the entity redeemed.

In the 1998 TAM, the IRS added an additional theory to attack the transaction, ruling that if the minority and lack-of-marketability discounts were appropriate in valuing the 99% limited partnership interest that the decedent in the TAM received in exchange for marketable securities, real estate interests and cash and cash equivalents, she made a gift, presumably to the owners of the limited partnership, equal to the difference between the fair market value of the property transferred and the limited partnership interest received. This is the "gift on creation" theory, as discussed in detail further below. It is arguable, however, that 99% of the gift was to herself, because she owned 99% of the partnership interest. It is also arguable that she received full consideration for what she gave up, even though the fair market value immediately after the transfer of her limited partnership interest was less than the fair market value of the assets she transferred to the limited partnership. Such a decrease in value occurs any time a person is transferring assets to an entity that the person does not control after the transfer.[39]

As one commentator has stated, the IRS's position that the entity be disregarded under I.R.C. § 2703 ignores the language of the statute, the Committee Reports indicating that Chapter 14 was not designed to eliminate minority discounts, and the principle that federal transfer tax applies to interests created under state law unless otherwise provided in the Code.[40] Thus, while restrictions in the limited partnership or LLC operating agreement may be disregarded for valuation purposes under I.R.C. § 2703 if they do not satisfy the three requirements of the statutory exception, the property interest should still be valued as a limited partnership interest or LLC interest and not as an undivided interest in the underlying assets. Whether I.R.C. § 2704(b) applies to cause restrictions on liquidation to be disregarded in valuing the interest depends upon state law and how the IRS defines an applicable restriction. I.R.C. § 2704(b) can be avoided by forming the limited partnership or LLC in a state, such as Colorado, that has a default rule depriving a limited partner or a member of an LLC of the right to withdraw.[41] See the discussion further below.

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[38] 113 T.C. No. 30 (1999).

[39] *See* Field Service Advice 19995014, in which the IRS expands upon its theory that a gift is made when a family member receives back an interest in the entity that is worth less than the property transferred to the entity in exchange. *See also* Louis A. Mezzulo, *supra*.

[40] Louis A. Mezzullo, *supra*. H.R. Conf. Rep. No. 101-964 (1990) at 1137.

[41] Louis A. Mezzullo, *supra*.

In *Church v. United States*,[42] the Court rejected all the positions espoused in the TAMs discussed above that the IRS had put forth in challenging the effectiveness of a limited partnership for transfer tax purposes.

The *Church* Court noted that there were two business purposes for forming the limited partnership: The partners wished to consolidate their undivided interests in the family ranch in order to provide for centralized management of their interests and preserve the ranch as an ongoing enterprise for future generations; and they wanted to protect the assets of Mrs. Church from judgment creditors in the event of a catastrophic tort claim against her that might have occurred because of her advanced age. The facts in *Church* supported the first business purpose. Mrs. Church and her two children owned 57% of the ranch, and members of another branch of the family owned the other 43%. Before the formation of the limited partnership, one of the members of the other branch (Mrs. Church's nephew) had exercised his rights as an undivided owner by moving onto the ranch and interfering with operations. He was then bought out by Mrs. Church, her two children and a cousin. Mrs. Church and her children were concerned that additional interests in the ranch would pass to the nephew, and, in fact, after the partnership was formed, the partnership used $200,000 of the securities that Mrs. Church transferred to the partnership to buy out additional interests that passed to the nephew. Mrs. Church transferred her interest in the ranch worth $380,038 and cash and securities worth $1,087,710 (a total value of $1,467,748) to the limited partnership. The Court accepted the testimony of the taxpayer's expert witness that the value of Mrs. Church's limited partnership interest at her death was $617,591, representing a 60% discount. The government chose not to present any valuation evidence of its own, relying on its positions that the limited partnership should be ignored for valuation purposes.

The Court rejected the IRS's position that Mrs. Church made a gift as a result of her transfer of assets to the partnership in exchange for a limited partnership interest that was worth less than the value of the assets she had transferred. The Court also rejected the IRS's arguments that § 2703 should apply to disregard the entity in its entirety or, alternatively, that any restrictions in the partnership agreement should be disregarded under § 2703.

Mrs. Church died two days after the partnership was formed, and before the certificate of limited partnership was filed with the Secretary of State. Moreover, the corporate general partner of the partnership was not actually organized and the PaineWebber account that held the securities was not actually transferred to the partnership until five months after the partnership was formed. The Court relied on these factors to conclude that Mrs. Church's health and her possible death were not motivating factors in the decision to form the partnership.

The Court also rejected the government's gift on formation theory, because the partnership in question was a pro rata partnership that did not confer a financial benefit on, or increase the wealth of, any partner as a result of the contribution to the partnership and because there was no donee.

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[42] 200 U.S. Dist. LEXIS 714 (W.D. TX., 2000).

Estate of Schauerhamer v. Comr., *supra*, and *Estate of Reichardt v. Comr.*,[43] both involved family limited partnerships. In *Schauerhamer*, the decedent formed a separate limited partnership with each of her three children and transferred a substantial percentage of her interests in the limited partnerships to family members, using the annual exclusion to avoid taxable gifts. She then deposited income from the partnerships in her personal account, in which she also deposited income from other sources, and used the account to pay her personal expenses as well as partnership expenses. The IRS argued, as it did in the recent TAMs discussed above, that the limited partnership interests should be disregarded based on its I.R.C. § 2703 analysis. The Tax Court held that the transferred interests should be included in the decedent's estate under I.R.C. §§ 2036(a) and 2038 and thus did not need to invoke Section § 2703. The Court found that there was an implied agreement that the decedent would retain the economic benefits of the property and, therefore, because the decedent had transferred property and retained the right to enjoyment of the income from the property until her death, the transferred limited partnership interests were includible in her estate under I.R.C. §§ 2036(a) and 2038. The *Schauerhamer* case exemplifies the importance of complying with all the formalities under state law and the terms of the operative agreements to ensure that the entity will be recognized under state law and that the property transferred to the entity will not be includible in the transferor's estate under I.R.C. §§ 2036(a) and 2038.[44]

In *Reichardt*, the decedent transferred 98% of his assets, including his residence, to a partnership. The Court held that all the assets were includible in the decedent's estate under § 2036(a), again based on an implied agreement that the decedent would continue to possess and enjoy the assets and retain the right to the income from the assets that he conveyed to the partnership during his lifetime.

[2] Swing-Vote Argument

[a] *Old Rule*

In Technical Advice Memorandum 9436005, the IRS raised the "Swing-Vote" argument. The donor owned 100% of the stock of a family business and transferred 5% to a spouse and 30% to each of three children. The taxpayer claimed a 25% discount on each gift and the IRS reduced this to reflect the fact that each recipient had the ability to combine with another to generate control. The IRS argued that when the second 30% gift was made, it carried with it the swing vote possibility that increased the value of the first gift and that this constituted a second gift to the first donee. Would a willing buyer and seller take into account the fragmentation of ownership? The answer is probably that they would take this into account, but that that would not be a significant factor.

Can the Courts look at the identity of the other shareholders or partners in calculating the value of the interest at hand? In the case of *Estate of Gallo v. Commissioner*,[45] the Court said that it may consider actual holdings of others in visualizing the willing buyer and willing seller.

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[43] 114 T.C. No. 9 (2000).

[44] *See* Louis A. Mezzullo, *supra*.

[45] 50 T.C.M. (CCH) 470 (1985).

The Service tried to argue in that case that only a Gallo family member would buy the 2% interest. The Court said that this ignored the fact that the purchaser must be *hypothetical*. However, the *hypothetical* purchaser would consider the holding of others.

The swing vote may in fact cause the Court to reduce the minority discount. See *Estate of Winkler v. Commissioner.*[46] Conversely, it may result arguably in a premium. See Professor Jeffrey N. Pennell, *Valuation Discord: An Exegesis of Wealth Transfer Tax Valuation Theory and Practice*.[47] However, the swing vote may help the taxpayer in increasing discounts. See Professor James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*,[48] where he points out that the willing buyer is an "unrelated" person who may take into account the family relationship and ties of the other shareholders. This would *inflate* the discounts.

[b] *New Rules on Swing Vote Value*

In *Estate of Davis*[49] two gifts were made of 25.77% each. The IRS agreed that because this block would give either of the two other shareholders effective control, the interest should be more valuable and the discount less. The court accepted the taxpayer's argument that the IRS gave undue weight that the block could create a swing vote with management.

[3] The Proposed IRC Section 701 Regulations

In 1994, the IRS issued a Notice of Proposed Rulemaking under IRC § 701 which proposed an anti-abuse rule under Subchapter K. The preamble to this indicated that it would also apply to the transfer tax provisions. Estate planners (unaccustomed to reading the Code below IRC § 2000) were shocked. Final Regulations were issued late in 1994 and these included two examples which purported to apply specifically to family limited partnerships in the estate planning context. While the IRS later withdrew these examples in response to the outcry that followed their being issued, they are indicative of the IRS position of fair play in the context of family limited partnerships. The first example made it clear that it would not be "fair" to fund a family limited partnership with a principal residence. The second made it clear that the partnership should exist for a period of time before the gift program was to commence. Timing is an important factor in discount planning. It is a good idea to follow these examples where the practicability of the matter will allow. However, how long should elapse before starting a gifting program is unclear.

[4] Passive Asset Partnerships

Notwithstanding Section 701, if the entity has been formed properly under state law, a limited partnership (or an LLC taxed as a partnership) should be recognized as a valid entity for transfer tax purposes even though the only assets it holds are marketable securities. The family partnership rules under I.R.C.§ 704(e) may disregard for federal income tax purposes a partnership that is valid under state law if certain criteria are not satisfied. For transfer tax

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46 57 T.C.M. (CCH) 373 (1989).

47 30, University of Miami, Philip E. Heckerling, Institute on Estate Planning, 1996, ¶ 905.2.

48 Tax Law Review, Vol 50

49 110 TC 35.

purposes, however, state law determines the property rights that are being transferred unless a specific provision in the Code mandates a different result.[50] Congress recognized that a partnership owning only marketable securities was valid for federal tax purposes when it amended I.R.C. § 731(c) in 1994 to address the tax treatment of partnership distributions of marketable securities.[51] Before its amendment, I.R.C. § 731 generally provided that a partner did not recognize income when he or she received property in kind as a distribution from the partnership; instead, his or her basis in the distributed property was the lower of the partnership's basis for the property or his or her basis in the partnership. On the other hand, a partner did recognize income if cash was distributed and the cash exceeded his or her basis in the partnership.[52]

Because marketable securities are now treated as cash when distributed to a partner, a partner receiving marketable securities may recognize taxable income when he or she receives marketable securities in a distribution.[53] Marketable securities will not be treated as cash if the partnership never held any assets other than marketable securities, indicating that Congress recognized that a partnership that owned only marketable securities is still a partnership for federal tax purposes.[54]

In addition, the Code defines a partnership as including a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on. I.R.C. § 761(a). A partnership holding only marketable securities should qualify as a financial operation. The Code allows an unincorporated organization to elect out of partnership treatment if the only purpose of the entity is investment and not the active conduct of a business.[55] Such an election would be unnecessary if an unincorporated organization holding nothing but marketable securities could not be treated as a partnership for federal tax purposes.

Estate of Winkler v. Comr., supra, suggests that the Tax Court may find that a valid partnership exists for tax purposes, regardless of the type of assets it holds.[56] In *Winkler*, parents and five children purchased lottery tickets from time to time that were placed in a bowl in the family's home. When a ticket purchased by the mother bore the winning number, the family applied for the winning proceeds as a partnership. Because state law required that the partnership have a written agreement in order to receive the proceeds, the family went to an attorney to have a written agreement prepared. The agreement provided that the mother and father were each entitled to 25% of any winning lottery proceeds and that the five children were each entitled to 10%. The Tax Court held that a partnership existed for federal tax purposes

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50 *See, e.g., Comr. v. Est. of Bosch*, 387 U.S. 456 (1967), *Aquilino v. U.S., 363 U.S. 509 (1960), U.S. v. Bess, 357 U.S. 51 (1958), Morgan v. Comr.*, 309 US. 78 (1940).

51 Pub. L. NO. 103-465, tit. VII § 741(a), 108 Stat. 5006 (1994).

52 *See* Louis A. Mezzullo, *supra*.

53 I.R.C. § 731(c)(1)(A).

54 I.R.C. § 731(c)(3)(C)(i), *See also* H.R. Rep. No. 103-826(I), at 446 (1994), *reprinted in* 1995 U.S.C.C.A.N. 2773. ("It is acknowledged that certain partnerships are formed for the purpose of holding marketable securities for investment or for sale to customers.")

55 I.R.C. § 761(a).

56 T.C.M. 1997-4.

based on an analysis of the facts under the family partnership rules and the broad definition of partnership that appears in I.R.C. § 761(a).

Finally, Treasury Department regulations under I.R.C. §§ 701, 704, and 761 include discussion of partnerships that are created solely for investment purposes.[57]

[5] A Gift Occurs When the Partnership Is Created

The IRS is now starting to attack discounts by using the gift tax regulations. It is clear that a gift can occur without their being any donative intent.[58] There is normally no gift where the transaction is in the ordinary course of business and at arm's length.[59] The Service has argued that a gift occurs when the partnership is established.

In the old case of *Kincaid v. U.S.*,[60] there was an 80-year-old taxpayer who transferred 5,700 acres of land valued at $634,000 to a corporation in which the taxpayer owned 34% of a single class of stock and received in return non-voting stock worth $171,300. The taxpayer argued that this was in the ordinary course of business. The Fifth Circuit, overturning the jury verdict, said that no businessperson would have entered into this transaction which subjected her land to all the restrictions inherent in the non-voting stock. While there may have been a business reason for doing this, there was no business purpose, only a donative purpose. This case was cited in the recent case of *Trenchard v. Commissioner*[61] where, again, there were multiple classes of stock and property was contributed to the family corporation in circumstances where value disappeared. The Court applied the subtraction method and argued that the value of what the taxpayer got back must equal what is put in. Interestingly, there is, so far, no case relying on this principle which deals specifically with family limited partnerships, but that will not stop IRS agents in the trenches from seeking to rely on these cases.

This argument has also been used by the IRS in the more recent case of *Estate of Mario E. Bosca*.[62] In this case, the family completed a recapitalization that made the children's stock voting and the parents' stock nonvoting. The Court relied on *Kinkaid* and *Trenchard* in concluding that there was a gift.

The IRS is trying to assert that a gift takes place when the family limited partnership or corporation is created. A counter argument is that there is no donee. However, the Regulations state that there is no need for an identifiable donee.[63] A better argument is that there is no transfer. It should be difficult for the Service to beat this argument (despite the contrary assertion by Professor Jeffrey N. Pennell in his article referred to above.)[64]

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57 *See* Treas. Reg. §§ 1.701-1(a); 1.704-3(a)(3); and 1.761-2(a).

58 *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945).

59 Treas. Reg. § 25.2512-8.

60 682 F.2d 1220 (5th Cir. 1982).

61 69 T.C.M. (CCH) 2164 (1995).

62 T.C.Memo. 1998-251

63 Treas. Reg. § 25.2511-2(a).

64 See Jeffrey N. Pennell, *supra*, ¶ 904.5.

[6] A Gift Occurs When the Taxpayer Relinquishes Control

A further case often relied on by the Service is the case of *Estate of Joseph A. Vak v. Commissioner*.[65] The Service uses this case to support the argument that a gift occurs when the taxpayer loses control of an entity. In *Vak*, the trustees of a trust had the power to distribute the assets among the beneficiaries (and the beneficiaries included the grantor). The grantor then gave up the power to remove and replace the trustee and the court held that this was a gift of the assets in the trust. While this case may be considered as support for the "revolving door power" (the person who has the power to remove and replace the Trustee is deemed to have the powers held by the Trustee), it does not support the notion that there is a gift of underlying property where a donor gives up control of an entity. The court in *Vak* specifically distinguished the *Vak* facts from a situation where a taxpayer who owned an entity transferred an interest in that entity to his children. The court stated as follows:

> "In *Whittemore v. Fitzpatrick*, *supra*, a father owning all 820 outstanding shares of stock in a family corporation transferred 600 shares by irrevocable trust deed for the equal benefit of his three sons. The court found that the transfer should be treated as three separate gifts for gift tax purposes. Under the present facts, a trust was created from which certificate holders might benefit in an amount that is currently undeterminable."

[7] Other Arguments Which The IRS May Raise

[a] *No Discount for Tenancies in Common*

The IRS will argue that there is no discount for tenancies in common or general partnerships other than the cost of partition. See the section on "Fractional Interests in Real Estate" below. There are several cases in which this argument has been rejected by the courts.[66] In *McCormick v. Commissioner*,[67] the Tax Court looked at the valuation of a real estate general partnership. Under state law, a general partner may dissolve the entity. Despite this, the Tax Court allowed a discount. The Court noted that dissolution will be time consuming but concluded that the discount would be less than the situation where the person could not dissolve the entity.

[b] *Chapter 14*

The IRS has begun to rely on IRC Section 2703 and 2704(b) to reduce discounts. This is discussed above and below.

[c] *The Burden of Proving Value Is on the Taxpayer*

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[65] 62 T.C.M. (CCH) 942 (1991).

[66] See, e.g., *LeFrak v. Commissioner*, 66 T.C.M. (CCH) 1297 (1993), and *Estate of Cervin v. Commissioner*, 68 T.C.M. (CCH) 1115 (1994).

[67] 70 T.C.M. (CCH) 318 (1995).

The IRS has successfully raised the argument that the taxpayer has not proved the discount. The burden of proving the discount is on the taxpayer. Discounts are not easy to prove, and the Courts have often found that the burden has not been met by the taxpayer. See the discussion on proving the value below.

[d] *The QTIP Marital Trust Is Aggregated with the Survivor's Trust for Valuation Purposes*

The IRS argued that the QTIP Marital Trust should be aggregated with the Survivor's Trust for valuation purposes.[68] This argument has been rejected by the 5th Circuit in the case of *Estate of Louis Bonner v. U.S.*[69] The IRS argued that IRC § 2044 treats the surviving spouse as if he or she owned the QTIP assets for all purposes including for valuation purposes. The Court rejected this argument noting that Mr. Bonner did not have control over the disposition of the QTIP trust assets at his death. The IRS has indicated a desire to litigate *Bonner*. See the detailed discussion of *Bonner* in M. Read Moore and Linda B. Hirschson, *Divide and Conquer: Aggregation of QTIP Trust Assets and Other Assets of a Surviving Spouse*.[70]

[e] *IRS Applies a Subjective Test*

As an alternative to family attribution, the IRS has also sought to move towards a more subjective test than the very objective willing buyer willing seller test that has generally been favorable to the taxpayer. In Private Letter Ruling 8401007, the IRS was considering the value of preferred stock in a family corporation where there was a right to liquidate. The IRS concluded that the preferred stock should be valued below liquidation value because of the unlikelihood of the liquidation privilege being exercised. Similarly, in the *Wallace* case[71], referred to above, the IRS argued that the class B common stock should be valued on the assumption that another class of preferred stock would not be converted into class B common stock, because the conversion would be contrary to the estate plan of the donor.

[f] *After-Death Facts*

There are a number of recent cases that support the notion that after-death facts may be taken into account in determining value at death. The IRS will use these to show that the value of partnership interests are equal to the proportionate value of the sale of the underlying assets made shortly after death.[72]

[g] *No Discounts for Joint Tenancy Assets*

The IRS has been successful in asserting that no discounts are allowed for assets held in joint tenancy. The Code (Sections 2040 and 2031) makes it clear that in the case of joint tenancy assets, the whole asset is valued and then you subtract the value of the half belonging to the other

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68 See TAM8608001.

69 See 96-2 USTC ¶ 60,237 (5th Cir. 1996)

70 Probate & Property (May/June 1997)

71 See *Wallace v. Commissioner*.

72 *See Estate of Ross Freeman*, T.C. Memo. 1996-372; *Estate of Willie C. Lloyd*, T.C. Memo. 1996-30; and *D.F. Rabenhorst*, T.C. Memo 1996-92.

joint tenant. The Tax Court followed this reasoning in the case of *Young Estate v. Commissioner*.[73] The Court concluded that at the moment of death, the joint tenancy is severed and the problems associated with co-ownership end.

[h] *Sham*

The IRS has been successful in asserting that no partnership exists where the formalities or the substance of the partnership (like dividing the profits) are not adhered to.[74]

[i] *No Discount for Marketable Asserts Inside the Partnership*

The IRS has taken the view that if the assets in the entity are marketable (like securities or cash), there should be no discount. This argument suffered a setback in *Davis v. Commissioner*.[75] This was one of the proposed legislative changes in the recent Clinton proposals but it as not made its way into the law.

These arguments and others will be used by the IRS in trying to control the flood of discounted gifts being filed. Its approach is logical when you realize few taxpayers have the interest, wherewithal or stomach to fight the issue. Regardless of the law, taxpayers realize they are getting a break and some discount is better than none. Eventually, this will probably be decided by Congress.

§ 1.4 DISCOUNT FOR LACK OF MARKETABILITY

[1] Introduction

There are several types of discounts allowed. The discount for lack of marketability is one of the discounts available to taxpayers. The discount for lack of marketability is available because of the fact that the asset in question is less attractive and more difficult to sell than publicly traded stock. This discount is recognized in the IRS's *Valuation Guide for Income, Estate and Gift Taxes* (but not given full credit - see the quote below). There have been numerous court cases that deal specifically with this discount.[76] However, many court decisions have confused the marketability discount with the minority interest discount discussed below. The minority interest discount deals with an interest where the owner has less than the controlling interest and therefore does not have managerial control. The marketability discount is one that comes about by virtue of there being a limited market for the entity in question.

The marketability discount applies both to the majority and the minority interest.[77] The minority discount, on the other hand, will only apply against the minority interest. An example of

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[73] 110 T.C. 24 (1998)

[74] See *Estate of Dorothy Schaverhamer*, T.C.Memo. 1997-202.

[75] 110 T.C. 35 (1998).

[76] See, e.g., *Central Trust Company v. United States*, 305 F.2d 393 (Ct. Cl. 1962); *Messing v. The Commissioner*, 48 T.C. 502 (1967), *acq.* 1968-1 C.B. 2. Moore, *Valuation Revisited*, 126 Trusts and Estates, 40 (Feb. 1987); Arneson, *Now Marketability Discounts Should Exceed Fifty Percent* , 59 Taxes 25 (1981).

[77] *Estate of Maxcy v. The Commissioner*, 28 T.C.M. (CCH) 783 (1969), rev'd on other grounds, 441 F.2d 192 (5th Circuit 1971).

the courts confusing the two discounts occurs in the *Central Trust Company* case referred to above where the court stated as follows:

> "Finally, the record indicates that all three experts took too great a discount for lack of marketability. Defendant disputes the propriety of taking this factor into consideration at all. It seems clear, however, that an unlisted closely held stock of a corporation ... in which trading is infrequent and which therefore lacks marketability, is less attractive than a similar stock which is listed on an exchange and has ready access to the investing public. This factor would naturally affect the market value of the stock.... In such a situation, a consideration of the factor is appropriate, especially where, as here, only a minority interest is involved."

[2] Distinguishing Marketability and Minority Interests

However, there are also cases which clearly distinguish the two discounts.[78] In the case of *Estate of Andrews v. The Commissioner*,[79] the court described the distinction as follows:

> "In their arguments neither Petitioner nor Respondent clearly focuses on the fact that two conceptually distinct discounts are involved here, one for lack of marketability and the other for lack of control. The minority shareholder discount is designed to reflect the decreased value of shares that do not convey control of a closely held corporation. The lack of marketability discount, on the other hand, is designed to reflect the fact that there is no ready market for shares in a closely held corporation. Although there may be some overlap between these two discounts in that lack of control may reduce marketability, it should be born in mind that even controlling shares in a non-public corporation suffer from lack of marketability because of the absence of a ready private placement market and the fact that flotation costs would have to be incurred if the corporation were to publicly offer its stock. However, the distinction between the two discounts is not crucial for purposes of this case. Because respondent's basis for opposing both discounts is the same - that the hypothetical willing buyer must be seen as a family member - our subsequent discussion, like the parties' briefs, will consider the two discounts together."

[a] *IRS Approach*

The IRS approach to the marketability discount is found in the IRS Valuation Guide which provides as follows:

> "...The most effective way to deal with arguments that marketability reduces the value of the stock is to indicate that you have taken it into

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[78] See, e.g., *Whittemore v. Fitzpatrick*, 127 F. Supp. 710 (D.C. Conn. 1954), Remanded to enter judgment per stipulation (2d Circuit 1955); *Estate of Piper v. Commissioner*, 72 T.C. 1062 (1979).

[79] 79 T.C. 938 (1982).

consideration in your overall appraisal of the stock and for that reason you have applied a conservative capitalization rate or weighted certain of the other factors from a conservative standpoint to give effect to this marketability factor."

[b] *Combining Both Discounts*

When both minority and marketability interest discounts are taken, they are not added together. The minority discount is placed on top of the marketability interest discount. For example, if there is a 30% marketability discount and a 30% minority interest discount, the total discount will be 50%.

[3] Applying Marketability Discounts to Majority Interests

There are a number of cases dealing with the application of the marketability discount to majority interests. In the case of *Estate of Folks v. Commissioner*,[80] the IRS had agreed that a discount should apply. The Tax Court allowed a 40% discount in a closely held real estate investment company where the decedent owned 62% of the outstanding stock. However, it should be noted that a 62% interest could not have forced a liquidation of the corporation under New York Law. In the case of *Estate of Ford v. Commissioner*,[81] decedent owned 92% of one of the corporations that was being valued and the court still allowed a 10% discount for lack of marketability. Then in the case of *Estate of Bennett v. Commissioner*,[82] the tax court allowed a 15% lack of marketability discount in a real estate management firm that was 100% owned by the decedent. (This concept had not been accepted by the IRS in Private Letter Ruling 7953001 where the IRS stated that there is no lack of marketability discount for a controlling interest in a closely held corporation.) The IRS had found support for its contention in *Estate of Jephson v. Commissioner*,[83] where the tax court refused to allow a discount for lack of marketability where the decedent owned 100% of the corporation. The Court based its conclusion on the unqualified right to liquidate the company and get at the shares. This case was specifically referred to by the Court in the *Bennett* case referred to above. The *Jephson* case dealt with a corporation owning liquid securities and the *Bennett* case dealt with a corporation owning real estate. The Court stated as follows in the *Bennett* case:

> "Each case must be judged on its own particular facts. *Estate of Jephson* represents a unique situation in which the decedent's complete ownership of the companies enabled ownership of the corporation's liquid assets through a partial or complete liquidation or a dividend in kind. A discount for lack of marketability was not warranted; yet, we still found it necessary to reduce the net asset values of the corporation by the transactional costs that would be incurred in obtaining that direct ownership. The corporate form cannot simply be ignored as respondent would have us do. The benefits and burdens of the corporate form are

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80 43 T.C.M. (CCH) 427 (1982).
81 66 T.C.M. (CCH) 1507 (1993).
82 65 T.C.M. (CCH) 1816 (1993).
83 87 T.C. 297 (1986).

often the very reasons upon which the decision to apply or to not apply a discount for lack of marketability is based."

The argument that the majority may liquidate the corporation was specifically rejected in the case of *Estate of Curry v. United States*,[84] where the Court held that the fiduciary duties of the controlling shareholder restrained the majority shareholder from liquidating the corporation without regard to the minority. In this case, the Court followed an earlier decision in *Von Hagke v. United States*.[85]

[4] Quantifying the Discount

There are three generally accepted methods of quantifying the marketability interest discount:

- Studies relating to the sales of restricted shares of publicly traded companies compared to the sales of unrestricted shares in these publicly traded companies are used to quantify the discount. The Securities and Exchange Commission made a study in 1971.[86]

- The sales of closely held company shares are compared to the prices of subsequent initial public offerings of the same company's share.

- The projected estimated costs of making a public offering are calculated.

Where the marketability discount has been recognized by the courts, it is a substantial discount. Several commentators have called for an increase in the amount of this discount.[87] What follows is an indication of the size of marketability discounts that have been granted by the courts in some of the cases:

- Korslin v. United States[88] - 20% discount.
- Maris v. Commissioner[89] - 30% discount
- Tallichet v. Commissioner[90] - 20% discount
- Estate of Hayes v. Commissioner[91] - 25% discount
- Knott v. Commissioner[92] - 30% discount

[5] Precluding the Discount

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84 706 F.2d 1424 (7th Cir. 1983).
85 79-1 U.S.T.C. ¶ 13,290 (D. Wis. 1979).
86 See The *Institutional Investor Study Report*, *H.R. Doc. No. 92-64, 92nd Cong.*, pages 2444-2456 (1971).
87 See Arneson. *Now marketability discounts should exceed 50%*, 59 Taxes 25 (1981); Moore, *Valuation Revisited*, 126 Trusts and Estates (February 1987).
88 73-1 U.S.T.C. ¶12, 907 (D.C. Wis. 1973).
89 41 T.C.M. (CCH) 127 (1981), *affirmed per curiam*, 670 F 2d 185 (11th Circuit 1982).
90 33 T.C.M. (CCH) 1133 (1974).
91 32 T.C.M. (CCH) 1102 (1973).
92 55 T.C.M. (CCH) 424 (1988).

The IRS has tried to argue in several cases that the facts of a particular situation in question will preclude access to the lack of marketability discount. For example, in the case of *Ward v. Commissioner*,[93] the Tax Court discussed the concept of a closely held corporation creating a market for its own stock where the facts support the notion of an eager and ready market for the shares of the company among the family members or other persons associated with the company.[94] [95] However, in the case of *Estate of Gallo v. Commissioner*,[96] the Tax Court specifically stated that this principle was an effort on the part of the IRS to personalize the hypothetical willing buyer, willing seller test and the Court therefore refused to follow it. However, this is an area where bad facts will give rise to an undesired result. See the case of *Estate of Neff v. Commissioner*,[97] where the marketability discount was reduced because of a corporation's practice of purchasing its shares at a premium.

In the recent case of *Mandelbaum*,[98] there was a family corporation with voting and non-voting stock and an agreement which restricted the transfer of shares. The court, in allowing a 30% marketability discount, looked at the following in deciding what the size of the discount should be:

- The difference between privately traded and publicly traded stock;
- The financial statements;
- The dividend paying capacity and history;
- The corporate history;
- The management;
- The control block;
- The time period during which an investor would have to hold the stock to realize profit;
- Restrictions on transferability;
- Redemption policy; and
- The cost of a public offering.

The taxpayer in this case had claimed a 70% discount.

In *Estate of Cloutier*,[99] the Court had to decide on the amount of the marketability discount for 100% of the corporation. The Court refused to allow a marketability discount on the ground that "a discount for lack of marketability is inapplicable when the value of unlisted stock is not determined by reference to the price of listed stock." The Court indicated that reference

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[93] 87 T.C. 78 (1986).

[94] See also the decision of *Rothgery v. United States*, 475 F.2d 591 (Ct. Cl.1973) (where a 50% interest was bequeathed to a son who held 49.5% and no discount was allowed, since the son provided the market).

[95] See also *Luce v. United States*, 84-1 U.S.T.C. (CCH) ¶13,549 (Ct.Cl. 1986) (where the market was created by the company always acquiring its stock, and no discount was allowed).

[96] 63 T.C.M. (CCH) 3115 (1985).

[97] 57 T.C.M. (CCH) 669 (1989).

[98] 69 T.C.Memo. 2852 (1995-225).

[99] T.C.Memo. 2001 1996-49.

should be made to publicly traded interests regardless of whether they are comparable. This case again shows the importance of having a proper appraisal to support the discount.

[6] *Newhouse* Case

An interesting case which illustrates a number of principles relating to discounts is the case of *Estate of Newhouse v. Commissioner*.[100] This case involved the interest of the estate of Samuel I. Newhouse in Advance Publications, Inc., a closely held company which was in the publishing business. The Service determined an estate tax deficiency in excess of $600,000,000 and imposed a civil fraud penalty under IRC § 6653(b) of more than $300,000,000. This was done despite the fact that the estate had relied on an independent appraisal prepared by a prestigious bank. The fraud penalty was relinquished by the government at trial.

[a] *Facts*

The decedent in the *Newhouse* case owned all of the Class A and Class B Common Stock of Advance Publications, Inc. Other family members owned the Preferred Stock. The Common Stock had the exclusive right to elect the Board of Directors. Both the common and the preferred stock participated in dividends. The rights of the various stockholders was, at best, unclear. Several distinguished lawyers gave evidence which was conflicting. It appeared that the Preferred shareholders would receive 78% of all dividends declared and that the Preferred shareholders would have a right to vote, as a class, on any corporate liquidation. Upon liquidation, the Preferred shareholders received a small fixed amount of money and the Common Stock would receive the lion's share of the corporate value (1.5 billion). The Common stockholders would receive the bulk of the value on liquidation, but the liquidation could be blocked by the Preferred shareholders. The incentive for their doing this was the 78% dividend. On the other hand, the dividend distributions were controlled by the directors who were in turn controlled by the Common stockholders.

[b] *Discount Fog*

The rights and obligations of the various parties in this corporation were so complex that it created what one can describe as "a discount fog." The rights of the parties under New York law was unclear. The court concluded that the value was substantially impaired by the minority participation in dividends and the inability to force a liquidation. The value ultimately placed on the Common Stock by the Court was below the value on the return, giving the taxpayer a complete victory. An interesting side issue in the case was its rejection of the subtraction method of valuation. This is the method of valuation that has been adopted by implication in IRC Chapter 14. In terms of this method of valuation, the asset is valued at its full underlying value and then the value of the limitation is subtracted from the whole. The court stated as follows:

> "The foundation of respondent's approach is his view that we must resolve the question of the various legal entitlements of the Common and Preferred Stock

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[100] 94 T.C. 14 (1990).

in his favor. Respondent's position assumes that a willing buyer would not be uncertain about the ability to dispose of the claims of the Preferred shareholders. In effect, respondent argues that a willing buyer would not hesitate to pay $1,231,800,000 as Baniewicz suggests, for the Advance Common Stock because of his ability to eliminate the Preferred Stock. This is an astonishing proposition on this record. Noted legal experts have given concrete views in this case. Petitioner's experts' opinions were unscathed by cross-examination. Their opinions were well-reasoned and persuasive. We believe the likelihood of the Common shareholders' legal rights to eliminate the Preferred is, at best, equipoise. The one thing the willing buyer would not have had is certainty about the ability to eliminate the Preferred at the values that respondent used in his subtraction method."

[c] *Control Premium*

A further side issue in the *Newhouse* case was the Service's attempt to apply a control premium to a 44.44% ownership interest in a closely held corporation known as N.B. Co. The court rejected that this amounted to control:

> "The owner of the 100 shares of N.B. Co. could not accomplish any of these actions. Baniewicz explained at trial that the owner of the 100 shares would have effective control because he would have the largest block of stock. Having a substantial or even the largest block of stock does not necessarily create effective controls, and it certainly does not in this closely held corporation. The owner of the 100 N.B. Co. shares enjoys no attributes of control. Participating in corporate decisions is a right that any stock interest may enjoy (and which in this case the other stock interests also enjoyed), but unless that interest controls (which in a closely held corporation typically means a majority interest), a control premium is unsupportable."

The concern with trying to apply *Newhouse* is the adverse consequences it may create. An overly complex corporate structure can do more harm than good. Also, creating confusion for valuation purposes could backfire if the IRS is able to determine the motive. Finally, how confusing must the entity be?

§ 1.5 FRACTIONAL INTERESTS IN REAL ESTATE

[1] Introduction

Fractional interests in real estate is used in lieu of the marketability discount. There are several cases which allow a discount for a fractional interest in real property.[101] The undivided interest in real property is different from the undivided interests in entities. One has to analyze

[101] See *Estate of Whitehead v. Commissioner*, 33 T.C.M. (CCH) 253; *Propstra v. United States*, 680 F.2d 1248 (9th Circuit 1982); *Mooneyhamm v. Commissioner*, 61 T.C.M. (CCH) (1991); and *Estate of Pillsbury v. Commissioner*, 64 T.C.M. (CCH) 284 (1992).

the rights of the individual owners and this should be compared to the rights of the participants in the entities referred to above. Each tenant in common has the right to the use of the property and can sell his or her interest in the property. Alternatively, the tenant in common can petition the Court for a partition of the property. If the property is not readily divisible, the Court will generally order the sale of the property. This will generally result in a forced sale.

[2] IRS Position

The IRS showed its hand on this issue in a private ruling where the discount was limited to the cost of the partition action.[102] In this PLR, the IRS relied on *Estate of Fittl v. Commissioner*,[103] where the Court had taken the position that partition was the best way to generate the most value out of the property.

[3] LeFrak and Cervin

The issue discussed above came up for decision in the recent case of *LeFrak v. Commissioner*.[104] In this case, the Petitioner had conveyed interests in twenty-two buildings to his children individually or to trusts for their respective benefit. The Petitioner then formed twenty partnerships with his children or the trusts and the buildings were transferred to the partnerships. The reason for this structure was to avoid reassessment for real property taxes. Although the IRS originally accepted the argument that partnership interests were transferred, the pleadings were later amended to include an assertion that this was a transfer of a fractional interest in real estate rather than a partnership interest. The taxpayer tried to rely on the step-transition doctrine in arguing that this was a transfer of partnership interest. The Court however concluded that this was a transfer of a partnership interest on the grounds that the acceptance of the taxpayer's position would mean that there is such a thing as a "one-person partnership." Notwithstanding the decision that was reached, the Court concluded that a discount for both minority interest and lack of marketability should be applied to the real property that was transferred. The Court stated as follows:

> "A minority interest discount for an interest in real property may be allowed on account of the lack of control which accompanies co-ownerships."

The *LeFrak* decision was confused by the fact that the taxpayer was arguing for a discount on a partnership interest and the IRS was contending that no discount should be allowed or that the discount should be limited to 15%, if one was allowed. The IRS was contending this without discussion of its position and despite the fact that its expert concluded that a combined discount of 30% should be allowed. The Court said that the burden was on the taxpayer here and that the taxpayer had failed to discharge the burden. The Court accepted the amount of the discount of the IRS' expert. In discussing the taxpayer's argument the court stated as follows:

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102 Private Letter Ruling 9336002.

103 52 T.C.M. (CCH) 567 (1986).

104 66 T.C.M. (CCH) 1297 (1993).

> "An interest in real property is not comparable to the entities proffered by Mr. Vlasak because the holders of interests in such entities do not have the ability to compel partition of the buildings. Although in their partnership agreements, the donor and donees agreed not to seek partition of the buildings, such restrictions did not come into being until after the conveyances, and so do not affect the value of the interests for tax purposes. The tax is levied based on the interest the donor possessed at the time of transfer, which was an unrestricted fee interest. As discussed above, in deciding the amount of discount allowable in the instant case, we think that consideration of the power to partition is appropriate due to the effect which the cost and delay involved in such a proceeding would have on value, which Mr. Vlasak has not provided."

In this case, the IRS did not try and argue the position it had taken in PLR 9336002. What is clear from *LeFrak* is that undivided interests in real property will give rise to a lower discount than a properly drafted partnership or corporation. The case suggests that an agreement between the tenants in common not to petition the Court for a partition will enhance the amount of the discount.

In *Estate of Cervin v. Commissioner*,[105] the IRS tried to limit the discount in a fractional interest in real estate to 5% plus the cost of partition. The estate claimed 25% and the Court granted a 20% discount. In this case, the 50% that was being valued passed to the holder of the other 50% interest. The facts of the case indicated that partition would reduce the value of the property because of issues like access, the amount of land needed for profitable agriculture, etcetera.

It is also interesting to note that the IRS has in the past used the fractional interest discount argument in real property to support a reduction in the value of a fractional interest being given to charity.[106] In this case the Court stated as follows:

> "We have given some weight to this argument (i.e., partitioning), but we are persuaded that a prospective purchaser would nonetheless refuse to pay the full aliquot portion of the entire value of the property for an undivided minority interest therein because of the procedural burdens, possible delays and costs involved in severance proceedings, and because of the lack of certainty as to just what portion of the property would be awarded to each party upon severance. Our ultimate conclusion in this respect is reinforced by Mr. Ingram's testimony that a minority undivided interest in the property would be difficult to sell and that he would advise a client against buying such an interest."

[4] Recent Cases

Two fairly recent cases have also allowed significant discounts for undivided interests in real property. *See Estate of Ellie B. Williams v. Commissioner*, 75 T.C.M. (CCH) 1758 (1998),

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105 68 T.C.M. (CCH) 1115 (1994).

106 See *Knapp v. Commissioner*, 36 T.C.M. (CCH) 1576 (1977).

and *Estate of Bonnie I. Barge v. Commissioner*, 73 T.C.M. (CCH) 2615(1997). In the *Barge* case, the Court present valued the interest in the real estate taking into account the time for a partition action and the cost of partition in arriving at a 25% discount. In the *Williams* case, the Court rejected the cost of partition argument and accepted a 44% discount for undivided interests in real property. Both cases involved timberland.

Timberland has been subjected to significant discounts where a fractional interest has been valued. In *Estate of Van Loben Sels v. Commissioner*,[107] the Court allowed a 60% discount for an undivided interest in eleven parcels of timberland, where the decedent owned 2.5% to 25% of a particular parcel. Compare *Harwood v. Commissioner*,[108] where a partnership interest in timberland was awarded a discount of 50%.

§ 1.6 MINORITY INTEREST DISCOUNTS

[1] Introduction

Desirable characteristics for claiming lack-of-control (minority) discounts include:

a. The lack of management or voting rights;

b. The absence of a right to require the entity to redeem the owner's interest (a put right); and

c. Restrictions on the owner's ability to transfer ownership rights to a third party.

The applicable sections of the Code that impact on the ability to take a lack-of-control (minority) discount or that affect the ability to qualify for the annual gift tax exclusion or to avoid inclusion in the transferor's estate include:

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

e. I.R.C. § 2036(a)(1), which requires the inclusion of property in the transferor's estate if a transferor retains the possession or enjoyment of, or the right to the income from, the property;

f. I.R.C. § 2036(a)(2), which requires the inclusion of property in the transferor's estate if a transferor has retained the right to designate the persons who will possess or enjoy the property or the income from the property;.

g. I.R.C. § 2036(b), which requires the inclusion of shares of stock in a closely held corporation in the estate of a transferor who retains

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[107] 52 T.C.M. (CCH) 731 (1986).
[108] 82 T.C. 239 (1980).

the right to vote the shares;

h. I.R.C. § 2038, which requires the inclusion of property in the transferor's estate if a transferor has retained the right to alter, amend, revoke, or terminate the transferred interest;

i. I.R.C. § 2701, which applies special valuation rules when an older family member transfers a junior or residual equity interest to a younger family member and retains a senior or preferred equity interest;

j. I.R.C. § 2703, which ignores a right or restriction for valuation purposes if it is not commercially reasonable.

k. I.R.C. § 2704(a), which treats a lapse of a voting or liquidation right as a taxable gift, if the lapse occurs during a transferor's life, or as part of the gross estate, if the lapse occurs at death; and

l. I.R.C. § 2704(b), which ignores an applicable restriction (a limitation on the right of an owner to liquidate his or her interest if it is more restrictive than state law) for valuation purposes.[109]

A minority discount reflects the fact that the taxpayer does not control the entity. Control is a relative concept. The willing buyer would look at the following in deciding whether he or she has control (while there are other factors that may be important to a willing buyer, these are the most significant):

- Controlling the future long-range planning goals of the entity.
- The control of earnings and the distribution of earnings.
- The ability to control executive compensation.
- The ability to force a liquidation.
- The control of the day-to-day management of the company.

Most courts have consistently distinguished this discount from other discounts.[110] However, note the occasional confusion between the minority and the marketability discount, discussed above.

[2] Control

[109] *See* Louis A. Mezzullo, *supra*.

[110] See, e.g., the *Estate of Bright v. United States*, 658 F.2d 999 (5th Circuit 1981); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982); *Propstra v. United States*, 680 F.2d 1248 (9th Circuit 1982); *Ward v. Commissioner*, 87 T.C. 78 (1986); *Gallun v. Commissioner*, 33 T.C. M. (CCH) 1316 (1974); *Kirkpatrick v. Commissioner*, 34 T.C. M. (CCH) 1490 (1975); *Righter v. United States*, 439 F.2d 1204 (Ct.Cl. 1971), 71-1 U.S.T.C. 12,758.

The concept of control will vary according to the type of entity involved. For example, if an individual is a general partner in a partnership which allows any one or more of the partners to force a liquidation, then the individual who only has a small percentage of the partnership will still be able to assert a considerable amount of control over the entity. Contrast, where an individual is involved in a limited partnership and is a limited partner without any power of liquidation. His or her right of control is very limited. In the case of a corporation, the percentage of votes required to force liquidation will be crucial.[111]

The IRS has recently acknowledged the existence of this discount even in family situations in Revenue Ruling 93-12, 1993-1 C.B. 202, discussed above.

Articles have been written about the concept of whether the sum of the parts will equal the whole.[112] The transfer of the first 49% of a corporation will generally constitute the transfer of minority interests and will be valued at less than the full value of the underlying assets in the entity. Transfer of the following 2% of the entity, will once again be valued as a minority interest and will in fact reduce the transferor's interest in the entity to below 50%. Appraisers have grappled with the concept of what has happened to the disappearing value at that time. Is there some kind of hidden gift? If there is a gift, who has received it? Except for the *Murphy* case (discussed above) and a few other aberrations, which practitioners will try and limit to the bad facts of those cases, the courts have consistently allowed a discount and there is no mention of any hidden gifts in the decisions.[113] In the case of *Heppenstall*, the donor owned 2,310 of the 4,233 outstanding shares of Heppenstall Company. He gave his wife and three children 300 shares each, which resulted in his owning less than the controlling interest. The Tax Court held that the gifts were of minority interests and stated as follows:[114]

> "In making the gifts Charles W. Heppenstall, Sr. did lose, or surrender, his control over the company, but he did not convey that control to any one of the donees or to all of them jointly."

[3] Rejecting Unity of Interest

As indicated above, the courts have consistently rejected the unity of ownership concept and have given credence to the splitting of interests due to community property or otherwise. See the *Bright* case referred to above where the court decided that the decedent's estate was entitled to a discount, where the decedent owned a 55% community property interest in a closely held corporation, on the grounds that the decedent actually owned only 27.5%. The discount was granted even though the decedent's husband still controlled a 55% block of stock after the decedent's death. Community property is clearly a very significant factor in substantiating minority interest discounts.

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111 *Estate of Folks v. Commissioner*, 43 T.C.M. (CCH) 427 (1982).

112 See Anna C. Fowler, "Valuation of Undivided Interests in Realty: When do the Parts Sum to Less than the Whole?," *Journal of Real Estate Taxation*, Volume 13 Number 2, Winter 1986.

113 See *Rushton v. Commissioner*, 498 F.2d 88 74-2 U.S.T.C. ¶13,017 (5th Circuit 1974); *Estate of Heppenstall v. Commissioner*, 8 T.C. M. (CCH) 136 (1949).

114 See also, *Whittemore v. Fitzpatrick*, 127 F. Supp. 710 (D.C. Connecticut 1954).

[a] *Prior Agreement*

One of the arguments raised by the IRS in favor of the unity of ownership concept which has been used to preclude a minority interest discount is the argument that there is an express prior agreement concerning the future of transferred stock between the donor and the donee.[115] If there is any evidence of a prior agreement, then a court may well follow these decisions. Any evidence of family discord should be raised in the appraisal.

In the *Blanchard* case, a sale was being negotiated at the time the gifts were made and the Court found that there was an informal agreement to sell the gift of property.

Where a taxpayer has voting control and attempts to segregate this from non-voting interests in the entity, then the value of the controlling interest will be attributed to the non-voting interests.[116] In this case the decedent owned both voting and non-voting stock. And the Court valued both classes as one interest using the argument that the decedent controlled the corporation. The Court stated as follows:

> "In our view both the law and common sense compel the conclusion that the fair market value of the non-voting stock in the hands of an estate with sufficient shares of voting stock to ensure the estate's control of a corporation cannot be less than the value of the estate's voting stock... to permit the hypothetical bifurcation of an otherwise integrated bundle of property for valuation purposes would severely undermine the estate tax system and permit abusive manipulation by inviting an executor to invent elaborate scenarios of disaggregated disposition in order to minimize total value."

[b] *Separating Non-Voting Shares*

In *Ahmanson Foundation v. The United States*,[117] the decedent's trust owned a 60% controlling interest in a holding company. The trust also held all the shares consisting of ninety-nine non-voting shares and one voting share of another company which was a corporate shell. At the time of Ahmanson's death, this shell company became entitled to receive the 60% voting interest in the first company. The Ahmanson Foundation was entitled to the ninety-nine non-voting shares of the shell company and the decedent's son received the one voting share. The Ninth Circuit rejected the estate's contention that the non-voting shares should be valued separately from the voting shares and stated as follows:

> "...it is undisputed that the value is to be determined at the moment of death. ...Therefore we are instructed to determine the value at the moment of death of the 600 shares of HFA stock and the 100 shares of Ahmanco stock. In so doing we must take into account any transformations of the property that are logically prior to its distribution to the beneficiary. In particular, as the District

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115 See *Driver v. United States*, 1976-2 U.S.T.C. ¶13,155 (D.C. Wisconsin 1976); *Blanchard v. United States*, 291 F.Supp. 348 68-2 U.S.T.C. ¶12,567 (D.C. Iowa 1968).

116 *Estate of Curry v. United States*, 83-1 U.S.T.C. ¶13,518 (7th Circuit 1983).

117 81-2 U.S.T.C. 13,438 (9th Circuit 1981).

> Judge recognized, we must take into account that Ahmanco has acquired the 600 shares of HFA as an asset. In short, we must valuate the HFA and Ahmanco share stock as of the moment of Ahmanson's death, bearing in mind that the HFA shares, in their entirety, have become an asset of Ahmanco. In effect, this is to valuate the Ahmanco stock... . We must distinguish however the effect of "predistribution" transformations and changes in value brought about by the testator's death, from changes in value resulting from the fact that under the decedent's estate plan the assets in the gross estate ultimately come to rest in the hands of different beneficiaries. The estate tax is a tax upon a transfer as the Foundation contends. However it is a tax on the privilege of passing on property, not a tax on the privilege of receiving property. "The tax is on the act of the testator not on the receipt of the property by the legatees." ...There is nothing in the statutes or in the case law that suggests that valuation of the gross estate should take into account that the assets will come to rest in several hands rather than one."

In the *Ahmanson* case the Service was successful in consolidating the entire holdings of the taxpayer for purposes of estate tax inclusion. However, the charitable transfer which took place subsequent to death was discounted in that it did not include a control element.

§ 1.7 CONTROL PREMIUMS

A control premium is the opposite of a minority interest discount. The government has attempted to use this concept to recoup what it has lost on the minority interest side. The IRS stated as follows in Revenue Ruling 59-60, 1959-1 C.B. 237:

> "The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock."

[1] Increasing Value

It is obvious that a willing buyer would pay more for a controlling interest in a corporation. However, the increase in value due to the control premium should not be as large as the discount available for lack of marketability. In effect, the value of the majority interest should still be less than the proportionate value of the underlying assets. But see the case of *Estate of Chenoweth v. Commissioner*,[118] where the Court held that 51% of the stock of a corporation may be worth more than the value of 51% of the underlying assets.

If a majority shareholder uses his or her position to strip out earnings through salaries and other fringe benefits, this will affect the value of all the shares of which the majority owner owns the majority. The majority holder will be in a position, generally speaking, to liquidate the

[118] 88 T.C. 1577 (1987).

corporation and this will result in the value of the underlying assets being the ceiling for the value of the majority interest. On the other hand, liquidation may not be a viable solution because of potential tax problems. The most compelling argument against the control premium is the fiduciary obligations of the majority shareholder referred to above.[119]

[2] Voting Stock

Estate of Salsbury v. Commissioner,[120] the decedent owned 372,152 shares of class A common stock of a corporation. This represented 51.8% of the 690,000 shares of voting stock. The value of the corporation was said to be thirteen million dollars. A 38.1% control premium was applied to the common stock to raise its value from $372,152 to $514,000. The approximate amount of $142,000 control premium therefore represented about 1% of the value of the corporation. The government had tried to base the control premium on the value of all the shares. The Tax Court in rejecting this argument stated as follows:

> "We find the above valuation approach unconvincing and unrealistic...A premium for control is generally expressed as the percentage by which the amount paid for a controlling block of shares exceeds the amount which would have otherwise been paid for the shares if sold as minority interests and is not based on a percentage of the value of the stock held by all or a particular class of minority shareholders."

This case of *Salsbury* suggests that it may be beneficial for the taxpayer to limit the number of voting shares in a corporation. However, in the case of *Makoff v. Commissioner*[121], the decedent had only 1% of the stock of the corporation. This 1% gave the decedent control of the corporation at the time of death. The Tax Court held that the value of the non-voting stock was equal to 60% of the value of the corporation and that the premium therefore attributable to control was equal to 40% of the corporation. This attempt by the Court to keep the value at 100% of the value of the corporation has been rejected in several cases and is clearly an oversimplification.

Finally, in the case of *Estate of Anderson v. Commissioner*,[122] the Court awarded a 20% control premium in circumstances where the decedent's 39 shares of common stock out of 60 shares were valued at 3,000 dollars per share, while the minority shares were valued at 2,500 dollars per share.

Most of the cases in this area reject the notion that the majority stockholder may favor himself or herself with respect to the corporation.[123] A better reason for a control premium appears to be the argument that the control allows the taxpayer to respond quickly to business developments and represents for the taxpayer flexibility of investment. Note that a decedent who

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[119] See the case of *Von Hagke v. The United States*, 79-1 U.S.T.C. ¶13,290 (D.C. Wis. 1979).

[120] 34 T.C.M. (CCH) 1441 (1975).

[121] 26 T.C.M. (CCH) 83 (1967).

[122] 31 T.C.M. (CCH) 502 (1972).

[123] See the *Estate of Curry v. The United States*, 706 F.2d 1424 (7th Circuit 1983); *Silverman v. Commissioner*, 33 T.C.M. (CCH) 1321 (1974), affirmed 538 F.2d 927 (2nd Circuit 1976).

resides in a community property state cannot have a majority control interest where the stock is part of a community interest.[124]

§ 1.8 ISSUES IMPACTING ON THE APPRAISAL

[1] **Discount for Corporate Tax Due on Liquidation**

[a] *IRS Position*

In 1991, in TAM 9150001, the IRS held that no discount should be allowed in a "C" Corporation for potential taxes on capital gains that might be incurred if the corporation was liquidated. The conclusion was reached on the basis that this tax was too speculative. The decedent's estate contended that a willing buyer would not pay full value for the underlying assets of the corporation but would look at the potential capital gains in determining the price of the stock. Prior to the repeal of General Utilities in 1986, the outside basis of stock would be allocated to the assets on liquidation. The Courts have supported the argument of the IRS in the past.[125]

[b] *Ignores the Marketplace*

After the repeal of General Utilities, the IRS takes the unreasonable position that to avoid the tax, the taxpayer may convert to an "S" Corporation, wait 10 years and liquidate.

The analysis in the ruling is inaccurate in that a willing buyer in the marketplace would take this tax into account.

In the Ruling, the IRS relied on the case of *Robinson v. Commissioner*,[126] where the Court held that installment notes could not be discounted for taxes that were due upon the sale of the notes. This is not a good comparison because the installment notes were owned outright and there is little doubt that the entity involved, whether it is a corporation or a partnership, and the type of provisions applying to the parties to the agreement, will impact the value of the interest in the asset.

[c] *Reduces Value of C Corp*

The tax ramifications make an ownership in a "C" corporation less desirable than an ownership interest in a partnership. Any respectable tax lawyer will tell a purchaser to avoid the corporation and to use a partnership or LLC. This makes the corporation less desirable from a purchaser's point of view. In the case of *Clark, Jr.*,[127] the Court took the built-in gain into account in allowing a 40% discount but stopped short of allowing a separate discount for the capital gain.

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[124] *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978).

[125] See *Estate of Cruikshank*, 9 T.C. 162 (1947); *Ward v. Commissioner*, 87 T.C. 78 (1986); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982); *Estate of Piper v. Commissioner*, 72 T.C. 1062 (1979).

[126] 69 T.C. 222 (1977).

[127] 75-1 U.S.T.C. ¶ 13,076 (DC N.C. 1975).

In the case of *Estate of Kett*,[128] the Court valued a 100% interest in a corporation and the IRS conceded a 40% discount. One may only assume that a large portion of this was for the built-in capital gain. There are also several cases where the IRS took this issue into account in a settlement at the door of Court and the attorneys have indulged in "kiss and tell."[129]

The Court upheld the discount for unrealized capital gains in the recent case of *Davis v. Commissioner*.[130]

In an "S" Corporation, there is generally no basis for taking a reduction in value for this built-in gain because of the ability to liquidate without this tax. However, if there are any "C" Corporation earnings and profits __ § 1374 unrealized gains in the entity, the built-in tax will reduce value.

[d] *Discount Now Allowed*

Accordingly, the court in *Davis* recognized that the willing buyer-willing seller fair market value standard necessitated the recognition of some discount or adjustment to value to reflect the built-in capital gains tax. More importantly, the Tax Court articulately distinguished the difference between (1) subtracting, dollar-for-dollar, the built-in capital gains tax and (2) allowing a discount or adjustment that satisfies the willing buyer-willing seller standard.

Affirmed. In *Eisenberg*, the taxpayer owned all the stock of a corporation whose only fixed asset was a commercial building that it rented to third parties. The taxpayer gave shares of stock in the corporation to her son and grandchildren. For gift tax purposes, she reduced the value of the gift stock by the full amount of capital gains tax that she would have incurred if the corporation had liquidated, or sold or distributed its real estate.

On appeal, the Second Circuit vacated and remanded the Tax Court's decision. Relying on *Davis*, the Second Circuit in *Eisenberg* held that an adjustment for potential capital gains tax liabilities should be taken into account in valuing the gifts of stock even though no liquidation or sale of the corporation or its assets was planned at the time the gifts of stock were made. The circuit court stated that because the General Utilities doctrine has been repealed, a tax liability upon liquidation or sale for built-in capital gains is not too speculative in this case.

§ 1.9 PROVING THE DISCOUNT

[1] REIT Approach

Once it has been established that the discount exists, proving the discount is extremely difficult. Generally speaking, the value of real property is proved using comparable sales (and where this method of valuation is available, it is used in preference to other methods of valuation). However, there are very few comparable sales of fractional interests in property. In

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128 T.C. 1742-94.

129 See the discussion by William H. Frazier, ASA, *How Corporate-Level Capital Gains Taxes Affect Fair Market Value*, Estate Planning, June 1996, Volume 23, No. 5, Page 198.

130 T.C. No. 9337-96, 110 T.C. No. 31, June 30, 1998.

the case of *Estate of Edgar Berg*,[131] the Court applied what has become known as the "Reit Approach." The expert calculated the discount "based on the value of interests in ... real estate investment trusts." The Reit Approach based the value of the discount on the market value of publicly traded real property partnerships and used this value in contrast to the value of the underlying real property in the partnership. In the *Berg* case, the taxpayer had applied a 60% discount for both minority interest and lack of marketability. The Service on the other hand asserted a 30% discount. The Court applied an under valuation penalty against the taxpayer in terms of Section 6660 on the grounds that the taxpayer's analysis was inadequate. The Court indicated that an appraisal should be fact specific to the transferor's interest. While the case law is helpful in determining the existence of the discount, it is not helpful in determining the amount of the discount which is fact specific to the particular case. The Court indicated that when using a comparable analysis of publicly traded companies one should consider companies which are similar to the entity in question. The publicly traded figures should then be adjusted for distinguishing factors of the corporation in question. For example, if the partnership in question is less diversified than the publicly traded entity, then the discount should be increased.

Appraisers often rely on the market for publicly traded partnerships to support discounts. This comparison may not be entirely correct. Part of the reduction in value, after the original contribution, is due to the syndicator's fee and part is due to the fact that the market perceives the partnership as having no value other than "unfulfilled tax benefits."[132] What is needed in each case, is a careful analysis of the publicly traded entity.

[2] Comparable Sales

In the case of *Pillsbury v. Commissioner*,[133] the Court stated that because the appraiser did not rely on any comparable sales and did not offer a specific method for determining how the discount had been calculated, no weight was to be given to the opinion of the appraiser. Similarly, in the recent case of *McCormick v. Commissioner*,[134] the Court did not accept either the taxpayer's or the IRS' evidence on discounts on Rule 144 or other restricted securities in determining the discount for lack of marketability because the evidence presented was not properly reconciled with the particular attributes of the partnership being valued. The Court did not say that this evidence was inappropriate, only that it had not been properly reconciled. The Court in this case again approved the REIT valuation analysis in determining the minority discount.

Where one is dealing with an entity and the parties are locked into the entity as in the case of a limited partnership, which will last for a specified number of years, then the income discounting approach will be the appropriate method of valuing the entity. This is discussed in greater detail later on in this outline.

[3] Penalties and Interest

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131 T.C.M. (CCH) 279 (1991).

132 See Professor Jeffrey N. Pennell, *supra*, ¶ 905.3.

133 64 T.C.M. (CCH) 284 (1992).

134 70 T.C.M. (CCH) 318 (1995).

Where the appraiser undervalues a particular property, there will be the potential of penalties. The IRS may waive the undervaluation and overvaluation penalties where there is a reasonable basis for the value claimed and where it was made in good faith.[135] Valuation in the estate tax area has both income tax and estate tax implications and the taxpayer is between the devil and the deep blue sea. On one side there is the overstatement penalty.[136] On the other side there is the understatement penalty.

The interest rate that will be paid on overpayments is the short term federal rate plus two percentage points. The rate that is paid on underpayments is the short term federal plus three percentage points.[137] There will be no interest on penalties until the penalty is billed by the IRS. An exception to this rule is the new estate and gift tax undervaluation penalty which will bear interest from the date that the return is filed.[138] A special interest rate will apply to deficiencies which are labeled substantial underpayments attributable to tax motivated transactions and this will be 120% of the usual interest rate on deficiencies.[139]

A professional appraiser who has been assessed a penalty under Section 6701(a) for aiding or assisting in the preparation or presentation of an appraisal which results in an understatement of tax, may be subject to disciplinary action. The appraiser may be barred from practicing before the IRS may decree that the appraiser's appraisals will have no probative effect before the IRS.

All appraisals which are secured by the taxpayer may be subpoenaed by the IRS. See *United States v. McKay*.[140] It may be possible to keep these appraisals confidential under the work product doctrine by having the attorney employ the appraiser. See Rule 26(b)(3) of the Federal Rules of Civil Procedure.

In a fairly recent decision, the Tax Court, in the case of *Buffalo Tool and Die Manufacturing Company v. Commissioner*,[141] indicated that it has no intention to continue splitting the difference in valuation cases. The Court stated as follows:

> "...we are left with only the pure factual issue, the value of each item of machinery as of March 21, 1973. As the Court repeatedly admonished counsel at trial, the issue is more properly suited for give and take of the settlement process than adjudication. The existing record wreaks of stubbornness rather than flexibility on the part of both parties, based upon "an overzealous effort...to infuse a talismanic precision" into their respective views as to valuation.... We are convinced that the valuation issue is capable of resolution by the parties themselves through an agreement which will reflect a compromise Solomon-adjustment, thereby saving the expenditure of time, effort and money by

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135 IRC 6659(e) and 6660(e).
136 Revenue Ruling 85-75, 1985-1 C.B. 376.
137 IRC 6621(a).
138 IRC 6601(e)(2).
139 IRC 6621(c)(1).
140 372 F.2d 174 (5th Circuit 1967).
141 74 T.C. 441 (1980).

> the parties and the Court - a process not likely to produce a better result. Indeed, each of the parties should keep in mind that, in the final analysis, the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of-the-road compromise which we suspect each of the parties expects the Court to reach. If the parties insist on our valuing any or all of the assets, we will. We do not intend to avoid our responsibilities, but instead seek to administer them more efficiently - a factor which has become increasingly important in light of the constantly expanding workload of the Court."

The Court announced its intention in the *Buffalo Tool and Die* case to penalize an overzealous party by accepting the decision of the other party.

Under the law before 1998, although the gift tax statute of limitations may have run, this may not be the end of the valuation dispute. The Tax Court in the case of *Estate of Smith v. Commissioner*,[142] rejected the decision in *Boatmen's First National Bank of Kansas City v. United States*,[143] and held that the IRS may reexamine and revalue the prior gifts in determining the rate of estate tax (-- note that only the estate tax marginal bracket is impacted by this). After 1997, there is a three year statute on gifts that are properly disclosed.

In the case of *Estate of Hall*,[144] the Tax Court held that where a value was placed on the FORM 706 return, lower values may not be substituted without cogent proof that the reported values were erroneous. Care must be taken at the time of filing of the Return.

Valuation has become the most significant aspect of discount planning. The valuation is often attacked by the IRS and found wanting by the Courts. Beware of the client who is too cheap to substantiate his or her discount.

§ 1.10 PRIVATE RESTRICTIONS

[1] Regulations

An example of private restrictions occurs where a buy-sell agreement has been entered into by participants in a corporation or partnership. The Regulations specifically provide for the value placed in the buy-sell agreement to be given effect where the restriction is also applicable during the lifetime as well as at the time of death.[145] The Courts in the past have given recognition to buy-sell agreements even though the price involved is less than the fair market value.[146]

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142 94 T.C. 872 (1990).

143 705 F. Supp. 1407 (W.D. Mo. 1988).

144 92 T.C. 312 (1989).

145 Treas. Regulation § 20.2031-2(h).

146 See *Estate of Weil v. Commissioner*, 22 T.C. 1267 (1954); *Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977); *Wilson v. Bowers*, 57 F.2d 682 (2nd Circuit 1932); *Estate of Reynolds v. Commissioner*, 55 T.C. 172 (1970).

The Regulations do indicate that the buy-sell agreement, in order to be effective, must be one which creates a fixed price, it must have a business purpose and must not be a device for passing on business interests to the natural object of the decedent's bounty at a bargain price. An example of this is in Private Letter Ruling 8140016 where the fixed price buy-sell agreement withstood IRS scrutiny in circumstances where the agreement was entered into by a father, a mother and one of their three children who was involved in the family business. The fact that the agreement benefited the one son as opposed to all three sons equally indicated a business purpose and the IRS accepted this argument.

[2] Case Law

There are certain cases which cast doubt on the efficacy of buy-sell agreement in question. An example of this is the case of *St. Louis County Bank v. United States*.[147] In this case, the agreement gave the corporation the right to purchase the decedent's stock under a formula that produced a zero value and the Court refused to accept this. The Court concluded that this agreement did not pass the business purpose test. There were several factors in the case which militated against the efficacy of the agreement. In short, the formula had been devised at a time that the company was an earnings based company and subsequent thereto it converted to a real estate holding company without significant earnings. The formula had been ignored in the case of a past death and shortly before the agreement was entered into the decedent had suffered two heart attacks.

In contrast, in the case of *Novak v. Commissioner*,[148] the Court found that a fixed price buy-sell agreement did set the price for estate tax purposes. The purchaser here was the decedent's brother who was probably not the natural object of his bounty. The Court held that the provisions of the Uniform Partnership Act which provided no one could become a member of the Partnership without the consent of all of the partners was sufficient to supply a lifetime restriction on the sale and that this satisfied the requirements of Regulation § 20.2031(h).

The IRS, despite this authority, has attempted to assert lifetime gifts when buy-sell agreements are entered into.[149]

This obligation to buy and sell at the time of death may be in the form of a mandatory requirement or it may consist of an option with a set price. A right of first refusal will not determine value.

[3] IRC Section 2703

Chapter 14 and, in particular, IRC Section 2703 has changed the rules relating to the use of buy-sell agreements to fix the value of property. Congress sought to add a new standard to buy-sell agreements which had to be satisfied in order for them to be binding on the IRS. IRC § 2703 provides that, in general, the value of the property will be determined without regard to

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[147] 674 F.2d 1207 (1982).

[148] 87-2 U.S.T.C. ¶ 13,728 (D.C. Nebraska 1987).

[149] See Private Letter Ruling 8612001.

any of the restrictions for the purposes of estate, gift and generation skipping transfer taxes unless certain requirements are met. It has to be a bona fide business arrangement, it must not be a device which passes assets on to family members for less than full and adequate consideration, and the terms must be comparable to similar arrangements entered into by persons in an arms length transaction. As indicated by the Senate Finance Committee Report on Chapter 14, the existing case law is left intact. Both the Regulations and the Senate Report indicate that each of these three tests stand alone.

Although the new provisions refer to a transfer between family members, the Regulations in anticipation of a possible change in the legislation, have substituted this with a reference to natural objects of the bounty of the transferor.[150] The Regulations go on to provide that there is a presumption that all tests will be satisfied if individuals who are not members of the transferor's family directly or indirectly earn more than 50% of the property subject to the right or restriction so long as the interest owned by non-family members is subject to the same restrictions as family members. In regard to the bona fide business arrangement test, this appears to be the same as that which existed under the prior law and if it may be shown that the agreement was entered into to preserve family control and unity, this should satisfy the test.

[4] Inadequate Consideration

In regard to the test dealing with whether the device is intended to pass assets on for inadequate consideration, this is clearly a separate and distinct test. The Regulations are not helpful in applying this test. It is therefore necessary to look at the case law. In the case of *Estate of Lauder*,[151] the Court held that the agreement was not binding for estate tax purposes. The Court came to its conclusion after noting the testamentary considerations that had influenced the parties and that the formula price did not reflect adequate and full consideration. The Court was influenced by the arbitrary manner in which the formula was chosen.

[5] Natural Object

The Regulations are also not helpful in determining whether the person is the natural object of the decedent's bounty. Some of the decisions are helpful in making this determination. For example, in the case of *Elvie Cobb v. Commissioner*,[152] the Court found that a friendly but businesslike relationship between the decedent, who was childless, and one Cobb did not make Cobb the natural object of the decedent's bounty. On the other hand, the IRS has indicated that nephews may be the objects of one's bounty.[153] The 3rd Circuit Court of Appeals has indicated that a son may not be the natural object of a father's bounty where there is the indication of hostility between the parties.[154]

[6] Comparability Test

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[150] Treas. Regulation §25.2703-1(b)(1)(ii).

[151] 64 T.C.M. (CCH) 1643 (1992).

[152] 49 T.C.M. 1364 (1985).

[153] TAM 8710004.

[154] *Bensel v. Commissioner*, 36 B.T.A. 246 (1937), Non-acquiesced 1937-2 C.B. 36, Affirmed 100 F.2d 639 (3d Circuit 1938).

The most difficult test to satisfy is the comparability test. The Regulations give four factors in determining whether this has been satisfied, namely:

- The expected term of the agreement;
- The current fair market value of the property;
- The anticipated changes in value during the term of the agreement; and
- The adequacy of any consideration given in exchange for the rights granted.

There is no indication as to the weight given to any factors or whether other factors may be relevant. Presumably other factors will be relevant and that this is only a guideline. The Regulations do provide some indication of what will amount to sufficient evidence of general business practices:

- Isolated comparables are not sufficient;

- If two or more valuation methods are commonly used in a business, a right or restriction will not fail to evidence general business practice if it uses only one of the recognized methods;

- It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement; and

- If the business is unique and comparables are difficult to find, comparables from similar businesses may be used.

It is not clear how this is going to be applied in practice. However, expert testimony is most likely to be a significant factor. It is also not clear how the IRS will regard the impact of different bargaining positions.

[7] Grandfathered Agreements

Agreements entered into before October 9, 1990, are grandfathered unless the agreement has been substantially modified since that date. A substantial modification is defined as follows:

> "Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that result in other than a de minimis change to the quality, value or timing of the rights of any party with respect to property that is subject to the right or restriction." See Regulation Section 25.2703-1(c)(1).

Where the terms of the agreement require periodic updating, the failure to update is presumed to create a substantial modification unless the parties are able to show that updating would not otherwise have resulted in a substantial modification. Where family members are added, this will be a substantial modification, unless the addition is mandatory or the added family member is assigned to a generation that is no lower than the lowest generation operated

by any existing party to the agreement (as determined under the Generation Skipping Transfer Tax Rules).

In a number of Private Letter Rulings, the IRS has made a determination whether a substantial modification of the agreement has taken place. For example, the transfer of stock by a shareholder to his children and the addition of children to the agreement was not a substantial modification.[155] Changes to the charter documents of the corporation (for example changes to the number of directors, provisions relating to indemnification of officers and the aggregate number of authorized shares) were also held not to be substantial modifications.[156] The split-up and reorganization of a partnership was held not to be a substantial modification where it was proposed that the existing transfer restrictions would apply to each of the reorganized entities.[157] A change in the interest rate for the installment payout in the buy-sell was not a substantial modification.[158]

There appears to be an advantage in being grandfathered under the old legislation. This will allow the taxpayer to escape the comparability test. However, an analysis of the *Estate of Lauder* case referred to above, indicates that the old law is not that much less onerous. For example, in the *Lauder* case, the Court said that the restriction must not be "lower than that which would be agreed upon by persons with adverse interests dealing at arm's length." This sounds similar to the comparability test.

The buy-sell agreement may establish the discount or it may establish a price that has no discount. This will depend on the formula.

The big question, however, is whether the valuation reduction in a family limited partnership or family LLC is attributable to restrictions described in IRC § 2703(a)(2). This Section provides that the value of property will be determined without regard to any restriction on the right to sell or use the property. If this Section applies, then the question is whether the taxpayer is able to fit into the safe harbor in IRC § 2703(b) (it is a bona fide business arrangement, similar to other business arrangements and not a device to transfer assets for less than full and adequate consideration). The family partnership or family LLC is certainly similar to arms-length transactions and it certainly has a business purpose, but is it not a device to pass assets to family for less than adequate consideration? Some commentators argue that if in excess of 40% of value disappears when the assets are place in a partnership, no one in their right mind would enter into a partnership or LLC agreement.[159] The fact is that partnerships and LLCs are entered into for all sorts of reasons. Some are entered into by family members and some by non family members. There is always a reduction in value. In most cases, the partners or members hope that the long term gain will outweigh the short term loss. How does one distinguish between a "device" that is tax driven and one that is not? Is every family partnership or LLC a

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[155] PLR 9248026.
[156] PLR 9221042.
[157] PLR 9152031.
[158] PLR 9152031.
[159] See Professor Jeffrey N. Pennell, *Valuation Discord: An Exegesis of Wealth Transfer Tax Valuation Theory and Practice*, 30 University of Miami, Philip E. Heckerling Institute on Estate Planning, 1996, Chapter 9, ¶ 904.3.

"device?" Professor Pennell hints at that. What if the family is a typical California dysfunctional family? Will the result be different?

[8] Device Issue

The Regulations under IRC § 2703 of Chapter 14 make it clear that the "device" issue is now separate and apart from the business purpose test. As pointed out by Professor Pennell, the *Lauder* case had already (before Chapter 14) started to separate out the "device" test. However, there is still no clear indication in the Regulations or in the cases how a taxpayer will be able to show that the entity is not a "device." The *Lauder* case indicates that the mere showing that the agreement is a bona fide business arrangement does not prove that it is not a device. Professor James R. Repetti[160] argues that the entity is unlikely to be a device "so long as the restrictions are not broader than necessary to achieve their business objectives." While this makes sense, the issue remains unresolved.

What is the answer to the big question of whether IRC § 2703(a)(2) can be extended beyond the buy-sell context to apply to restrictions in every family LLC or family partnership that hinder the right to use and sell the underlying assets? There is no clear case dealing with this issue and no clear answer.

Professor Pennell suggests that IRC § 2703(a)(2) may, in fact, help the taxpayer in establishing that there is no gift on the formation of the entity. If the restrictions are ignored for valuation purposes, then the partnership or LLC interests have the same value as the underlying assets. Furthermore, he concludes that it will not materially hurt the taxpayer at the second leg when the sliver gift is made and when there are "few, if any, restrictions per se on the sale or use of the ownership interests, other than those the market imposes on non-marketable or minority ownership interests." Jeffrey N. Pennell, *supra*, ¶¶ 904.5 and 904.6. It may be that the inability to become a partner without the consent of the other partners will be hit by IRC 2703(a)(2) and ignored for valuation purposes. However, Professor Pennell concedes that there is no clarity on this issue. He concludes that when all is said and done, the application of IRC § 2703(a)(2) gets us back to the minority, marketability analysis referred to above.

[9] Technical Advice Memoranda

The Service has issued a number of Technical Advice Memoranda on discounts where they have relied on IRC § 2703.[161] Most of the recent TAMS deal with "imminent death" situations, and the Service has combined the *Murphy* case with IRC § 2703 to unwrap the partnership and then to ignore the restrictions on transfer. The Service had the chance to litigate the IRC § 2703 issue to a recent case in Texas, but they declined to take the opportunity, apparently in a common example of forum shopping.[162]

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[160] *Minority Discounts: The Alchemy in Estate and Gift Taxation*, Tax Law Review, Vol 50, p. 455.

[161] TAM 9719006 Jan. 14, 1997; TAM 9723009 Feb. 24, 1997; TAM 9725002 March 3, 1997; TAM 9730004 April 3, 1997; TAM 9735003 May 8, 1997; TAM 9736004 June 6, 1997; and TAM 9842003 (July 2, 1998).

[162] See S. Stacy Eastland and John W. Porter, "*Defending the Family Limited Partnership -- Estate of White v. Commissioner In The United States Tax Court Docket No. 14412-97*, 23 ACTEC Notes 278 (Spring, 1998).

This IRC § 2703 argument flies in the face of the position taken by the Court in the *Lauder* case and the *McClatchy* case (referred to above) where the Court said that the interest transferred is the subject of the valuation and not the underlying asset. Furthermore, Congress stated in the legislative history leading up to Chapter 14 that discounts would continue.[163]

[10] The Cash Flow Method of Valuing Limited Partnerships and Other Entities

[a] *Introduction*

If it is justifiable to value a limited partnership and other entities by capitalizing their distributable cash flow, it would obviously be easier for the planner to pass the family business on to the children without the threat of losing it due to transfer taxes. Most family businesses would be valued lower than at their liquidation value if valued using the distributable cash flow. Most family businesses generally reinvest the bulk of their earnings back into the business rather than distributing them to the owners. A purchaser, who does not have control of the business (because he or she is purchasing a limited partnership interest), would take this fact into account in valuing the interest. This purchaser would not have access to the internalized earnings of the partnership. Courts have generally found a difference between the value of the cash flow of the business and the underlying value of the assets of the business. These differences range between 40% to 85%. The right to value the business at the capitalized distributable cash flow basis is dependent on the ability to *liquidate* the businesses. If the parent does not have the power to liquidate the family business, it is arguable that the business will be valued at the lower value (the cash flow method).

An illustration of how the partnership may be valued on a cash-flow basis is seen in the case of the *Estate of Harrison v. The Commissioner*[164] and in the case of the *Estate of Watts v. Commissioner*.[165] [166]

[b] *Section 2704*

Congress has responded to the *Harrison* and *Watts* decisions with the introduction of IRC § 2704. This provision contains two prohibitions. Subsection (a) provides that lapsed voting or liquidation rights in a family controlled corporation or partnership will be treated as a transfer for estate and gift tax purposes. IRC § 2704(a) will not apply where there is no lapsing of a voting or liquidation right.

Subsection(b) of IRC § 2704 disallows consideration of certain restrictions on liquidation rights when valuing the transfer of an interest in a family controlled corporation or partnership.

Congress has stated in the legislative history leading up to the changes in Chapter 14 of the Code that minority and marketability interest discounts under existing law would continue.

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163 Conference Committee Report, H.R. 5853, 101 First Congress at 157 (October 27, 1990).
164 42 T.C.M. (CCH) 1306 (1987).
165 51 T.C.M (CCH) 60 (1985), affirmed 823 F.2d 483 (11th Cir. 1987).
166 See also the case of *Estate of Catherine Campbell v. Commissioner*, 59 T.C.M. (CCH) 133 (1972) where the Court looked at both this method and underlying value in valuing the partnership.

See Conference Committee Report, H.R.5835,101 First Congress at 157 (October 27, 1990). What is not clear is whether IRC § 2704(b) indirectly achieves what Congress stated in the legislative history was not intended to achieve. IRC § 2704(b) appears on its face to prevent the valuation of family partnerships or LLCs in most instances at their capitalized distributable cash flow value.

[c] *Harrison Case*

In the Harrison case, the decedent owned a 1% general partnership interest and a 77.8% limited partnership interest at the date of death. The partnership was formed by the law firm of Baker and Botts at a time when the Harrison's son, Dan, acting on a power of attorney was managing his father's affairs because of the father's declining health. Shortly before death, the decedent had contributed properties worth $59,476,523 to a partnership. He received a 1% general partnership interest and a 77.8% limited partnership interest. The two sons had contributed property worth $7,981,351 for the remaining 21.2% of the general partnership interest. The partnership agreement provided that if a general partner died, the surviving partners had an option to purchase the general partnership interest of the decedent. Each of the general partners had the right during life to dissolve the partnership. A limited partner did not have the right to dissolve nor did a successor general partner. Both the general and the limited partner had the right to sell their interests after first giving the other general partner a right of first refusal. Shortly after the decedent had died of a stroke, the sons exercised their option to purchase his 1% general partnership interest for $757,116 which is an amount that the Service and the executors had agreed was the value for federal estate tax purposes. The sons then decided to continue the partnership. The main issue in this case was the value of the 77.8% limited partnership interest belonging to the decedent. The Service had alleged that it was worth $59,550,020. This was basically the dissolution value. The taxpayers in the Harrison brief provided as follows:

> "Value does not appear and disappear frequently in ordinary transactions. If that is not apparent, only some thought is needed to make it so. Suppose A, B and C, contribute a $100 each to form a corporation, each receiving one share. With only one share, none of them alone can force a liquidation as to get his $100 back. Under the willing buyer -willing seller test, what is the value of A's share? The value has decreased from $100 contributed to something much smaller, perhaps $45, that reflects the loss of a right to liquidate. Where does the lost $55 go? It did not go to B or C, for each of them has suffered the same $55 loss. Such a loss may continue indefinitely as the corporation does business. We can see that readily by noting that the stocks of hundreds of corporations sell on exchanges at substantially below liquidation values."
>
> "Before proceeding to the changing value cases, it may be helpful to analyze another example of a split value case in order to emphasize the difference from the present case. Suppose a corporation has three shareholders, A, B and C, who have agreed that any of them can during life put his stock to the corporation for a $100, but that upon death, the stock must be redeemed at $50. The stock of a shareholder thus would drop at his death in value from $100 to $50, but the stock of B and C would have increased in value. Value would have split off from A

stock and transferred to B and C. The estate tax value of A stock would be $100 not $50. All of the elements of a taxable split value case are present in this example: The value of the decedent's stock decreased at his death. The decedent could have prevented that decrease in value by his voluntary act during his life. There is at the decedent's death a corresponding increase in value of the stock of other shareholders.

In the present case, [the *Harrison* case], the first two elements are present, but the third one, is clearly and significantly, absent. That absence is what makes a transfer tax operate only with regard to the decreased value."

In the *Harrison* case, the Tax Court found that there was a business purpose for the formation of the partnership and that the discounting of the value was appropriate.

[d] *Anti-Harrison Provision*

[i] IRS 2704(a)

IRC 2704(a) effectively relieves the Service from establishing the third element referred to above. It was described in the Committee reports as the anti-Harrison provision. IRC § 2704(a) will apply in the following way:

- Where there is a lapse of a voting or liquidation right in a corporation or partnership. This may be increased by the Service to include other rights by way of regulation.

- The individual holds such right immediately before the lapse and a member or members of such individual's family hold (both before and after the lapse) control of the entity.

- If the elements described above are present, then the lapse will be treated as a transfer of stock.

- The measure of the transfer is the excess of the value of all interests in the entity held by the individual before the lapse (which will be determined immediately after the lapse as if the lapsed right was non-lapsing) over the value of such interest immediately after the lapse determined as if all interests were held by one individual.[167]

[ii] Technical Advice Memoranda

The IRS' third alternative position in all of the recent TAMs addressing valuation discounts for family limited partnerships (see the discussions above) has been that Section 2704

[167] See Regulation 25.2704-1(d).

applies, most typically relying on the infamous *Example 5* of Treas. Regulations § 25.2704-2(d).[168] See the discussion below.

[iii] Restriction to Liquidate

In the *Harrison* case, the agreement provided that upon the death of a general partner, the general partner's legal representative was required to give the remaining general partners an option to buy the deceased partner's general partnership interest. As indicated above, the children exercised this option for $757,116.00. A prospective purchaser of the limited partnership interest would only have acquired an interest in the family partnership that he or she could not dissolve or control. Obviously, this was worth much less than the equivalent share of the partnership assets. The Tax Court stated as follows:

> "The difference between the two values is attributable entirely to the right which the decedent has as a general partner up until his death to force a dissolution of the partnership. The parties agree that under the partnership agreement and applicable Texas law, this right did not pass to the estate."

The Tax Court held that the correct value of the decedent's interest in the partnership was $33,000,000. The main reason for the decision was the restriction on a purchaser to liquidate the partnership. The Court went on to state as follows:

> "A potential buyer focuses on the value the property has in the present or will have in the future. He attributes full value to any right that vests or matures at death, and he reduces his valuation to account for any risks or deprivation that death brings into effect such as the effect of the death on the brains of a small, close corporation. These are factors that would affect his enjoyment of the property should he purchase it and on which he bases his valuation."

[e] *Business Purpose*

Although the *Harrison* decision has been substantially affected by the new legislation, there were several more ancillary issues decided in this case which are still relevant today. The first issue is whether a family partnership has any business purpose. The IRS argued that the partnership in this instance had been created to depress the value of the decedent's property for estate tax purposes. This argument was rejected by the Court which accepted that the partnership was created to provide necessary and proper management of the decedent's properties as well as tax savings.

The IRS had argued that the transfer of the general partnership interest at death was made without adequate consideration. The Court however concluded that full consideration was given. The IRS also argued that the forfeiture of the right to dissolve the partnership at death was made without full consideration and that the entire partnership should be included in the estate under

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[168] See TAM 9725002 (March 3, 1997); TAM 9730004 (April 3, 1997); TAM 9735003 (May 8, 1997); TAM 9736004 (June 6, 1997); TAM 9804001 (Sept. 30, 1997); TAM 9842003 (July 2, 1998).

IRC 2037. The Tax Court disagreed, concluding that there was full consideration given. An ancillary issue that was raised was to whether the partnership qualified under IRC 6166 for deferment of the payment of estate taxes. The Court concluded that this contribution to the family limited partnership did not impact the qualification.

In the *Watts* case referred to above, the decedent owned a 15% partnership interest in an Oregon general partnership engaged in the manufacture and sale of lumber taken from its own lands and lumber purchased from others. The partnership also included a large portion of timberland. The remaining partnership interests were owned by members of the decedent's family. The partnership agreement provided that a partnership interest was not to be sold to outsiders. The stated intention of this was to keep the business intact in the family. The partnership yielded a small return on the value of the underlying assets. The government tried to argue that the 15% interest was worth approximately $20,000,000 and that a 20% discount was justified. The Tax Court, however, accepted the argument that the liquidation value was not appropriate and that the only appropriate method of valuation was a capitalization of the earnings method. This method gave rise to a value of approximately $3.9 million and the Tax Court applied a 35% minority interest discount resulting in a final valuation of $2,550,000. However, see the case of *Catherine Campbell v. Commissioner*,[169] which stated that some weight had to be given to the liquidation value.

[f] *Liquidation*

The new Chapter 14 provisions should be analyzed in the light of the two cases referred to above. The big question is whether the *Harrison* decision would be affected by the new provisions. There was no lapse of voting rights in the *Harrison* decision. A lapse of a voting or liquidation right is defined in the Regulations as follows:

> "A lapse of a voting or liquidation right occurs at the time a presently exercisable right is restricted or eliminated. Generally, a transfer of an interest conferring a right is not a lapse of that right because the rights with respect to the interest are not restricted or eliminated." See Regulations 25.2704-1(c).

Under no circumstances can it be alleged that the transfer of an interest is a lapse even though the transfer results in the loss of voting control by the transferor.

A further exception under IRC 2704(a) would arise where the transferor's family do not have the power to obtain a liquidation. It all depends on state law. If state law allows for a termination of the partnership before the end of the term by the agreement of less than 100% of the partners, then the non-family partners would have to exceed that percentage in order to be able to prevent the application of IRC 2704(a). Both The Uniform Limited Partnership Act and The Revised Limited Partnership Act require the consent of all of the partners in order to terminate the partnership before the end of the term.

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[169] 62 T.C.M. (CCH) 1514 (1991).

IRC 2704(a) does not apply where the liquidation or voting right was previously valued under IRC 2701(a).[170] Finally, this Section will not apply where there is a change in state law which causes the lapse.[171]

The affect of IRC 2704(a) is to value the partnership interest and its liquidation value instead of its going concern value. Obviously, this Section will only have an impact on value where there is a disparity between those two figures. What is not clear from this Section is who will be responsible for the tax under IRC 2704(a) where the total estate tax exceeds the value of the assets being transferred. It would be unfair to tax the recipient in an amount in excess of what he or she receives.

It would also seem that the bankruptcy or the incompetency of the general partner of a family limited partnership which automatically converts to a limited partnership interest could trigger the tax under IRC 2704(a). In both instances, there would be a deemed lapse of the voting rights associated with the general partnership. It is suggested that these lapsing provisions be omitted from the Partnership.

[g] *Section 2704(b)*

IRC § 2704(b) offers the Service a new opportunity to attack discounts in the context of a family owned partnership or limited liability company.

Under IRC § 2704(b), a liquidation restriction will be disregarded in determining the value of a transferred interest in an entity in the following circumstances:

(a) There is a *transfer* of an interest in a corporation or partnership to a member of the transferor's family;

(b) The members of the transferor's family control the entity; and

(c) There exists a restriction on liquidation with respect to either of the following:

(i) The restriction lapses after a transfer to a family member; or

(ii) The transferor or any member of the transferor's family, either alone or collectively, have the right after such transfer to remove in whole or in part the liquidation restriction.

The liquidation restriction will be ignored where it is more restrictive than the limitations that would apply under "generally applicable" state law. See Regulation § 25.2704-2(b). Where it is more restrictive than state law, the Regulations suggest that the state law position will apply.

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170 Treas. Regulation 25.2704-1(c)(2) and (ii); Proposed Regulation 25.2704-1(h), examples 9 and 10.

171 Treas. Regulation 25.2704-1(c)(2)(iii).

There are certain exceptions to IRC § 2704(b). It will not apply to any financing or equity participation entered into by the corporation or partnership with a person who is unrelated, as long as the restriction is commercially reasonable *or* is imposed or required to be imposed by federal or state law.

For example, the parents and the children are partners in a limited partnership. The general partners are the parents and the children. The limited partners are also the parents and children and they may not withdraw from the partnership before the end of the term of the partnership. The consent of all of the partners is required for a termination prior to the end of the fixed term. Is this a liquidation restriction? The answer appears to be yes.

[h] *Partnership or LLC*

In assessing whether a partnership or an LLC is more suitable for discount purposes, it therefore becomes critical to establish whether the fallback position under state law will allow a partner or member to either liquidate the entity and force a partition or extricate himself or herself from the entity by forcing the other partners to buy his or her interest. If a partner or member is able to extricate himself or herself from the entity, the second question that will apply is whether the price he or she is able to obtain is his or her proportionate share of the underlying assets or the discounted value of his or her minority, non-marketable interest.

[i] *State Law*

This brings us to the question of "generally applicable" state law. Although the Regulations under IRC § 2704(b) speak of generally applicable state law, it is not defined. It is also not clear from the Regulations whether reference is being made to permissive rather than mandatory provisions under state law. Apparently, the IRS national office takes the position that there is an applicable restriction in every fixed term family limited partnership or LLC. This is a very expansive interpretation of the Code and regulations and is unlikely to be followed by the courts. The better view appears to be that the generally applicable state law is the fallback position in the state law statute. In other words, what would the state law be if the document was silent on the issue.

[j] *Georgia*

Each state has a different fallback position. There are some states, like *Georgia*, where the new Georgia Revised Limited Partnership Act provides that a limited partner may withdraw from a limited partnership at a time and upon the events, specified in the partnership agreement. In other words, no limited partner has a withdrawal right in the absence of such a right being created in the partnership agreement. IRC § 2704(b) would appear not to apply to this law at all.

What will be the effect of shopping around for the best state law position? There is no decided case on this issue despite the fact that taxpayers have for years been selecting state jurisdictions that suit their purpose. This suggests that this will not be attacked in the same way as it has been in the international context where taxpayers "treaty shop."

[k] *RULPA*

Most states which have adopted the *Revised Uniform Limited Partnership Act* have statutes which provide that a limited partner may withdraw from the partnership at the time specified in the agreement, or with the consent of all of the partners. If the consent is not given, and if the partnership agreement does not specify the time or the events for a withdrawal, then the limited partner may withdraw on not less than six months written notice. If the withdrawal violates the partnership agreement, then damages may be applicable. A restriction on withdrawal would be an applicable restriction.

Where a state has a requirement in its law that the partnership Certificate state the time at which the limited partnership is to be dissolved, is this an "applicable restriction"? The Certificate of Limited Partnership is required to state the latest date on which the partnership may be dissolved, and it is not possible to form the entity without the restriction in the Certificate of Limited Partnership. It would appear that this type of restriction is not more onerous than state law and is, therefore, not an applicable restriction.

[l] *Delaware*

In some states, like in *Delaware*, it is not a requirement that the Certificate of Limited Partnership state the latest date on which the limited partnership is to be dissolved. It is more likely that this will be ruled an applicable restriction.

If one concludes that the restriction on liquidation is an applicable restriction and the limited partner may withdraw on six months notice, then the put provision in the Revised Uniform Limited Partnership Act is the next arena of battle. What is "fair value" that the limited partner will receive?

[m] *California*

The *California* limited partnership law does not cause the partnership to terminate on death or withdrawal. Under California law, the partnership will be dissolved (except as otherwise provided in the agreement) when all of the general partners and a majority of the limited partners agree.[172] A restriction on dissolution that is not more onerous than this is not an applicable restriction. Furthermore, limited partners can't withdraw except as provided in the agreement. [173] General Partners who withdraw become limited partners.[174] However, note that a majority in interest of the limited partners could replace the general partner and dissolve the entity. If the general partner dies in California, the entity will not dissolve if there is another general partner or a majority of the limited partners elect to continue the business.[175] You do not want the entity terminating on death.

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172 Cal. Corp Code § 15681(b).

173 Cal. Corp. Code § 15663.

174 Cal. Corp. Code § 15662.

175 Cal. Corp. Code § 15681(c).

If one is valuing a limited partnership interest, under California law, the limited partner is not entitled to withdraw unless the operating agreement provides otherwise. If the limited partner owns less than a majority in interest then the limited partner cannot remove the general partner and effect the dissolution through the back door. The one weakness in the family limited partnership is the ability of the majority of the limited partners to replace the general partner and thereby to dissolve the entity by a vote of all of the generals and a majority in interest of the limited partners. If a majority limited partnership interest is being valued, it may be arguable that the discount is reduced to that which would apply to tenancy in common interests.

If the subject of the appraisal is a majority of the general partnership interests, without owning a majority of the limited partnership interests, then, while the general partner ostensibly has control of the entity, he or she will be locked into the entity. This should allow for some discount and certainly would result in the entity being valued according to its income stream as opposed to the value of the underlying assets. There will also be a marketability interest discount, but again this will be significantly reduced. Under California law, this general partnership interest will convert to a limited partnership interest in the event of death. However, this will be treated as a lapsing right under IRC § 2704(a) and will therefore not give rise to any reduction in value at the time of death.

If there is a co-general partner, this will significantly reduce the amount of control and this will also increase the marketability discount (in comparison to the situation where there one general partner).

The same rules apply to LLC interests. In fact, most LLC statutes have adopted provisions similar to those contained in the Revised Uniform Limited Partnership Act. In the *ABA Prototype LLC Act*, the draft *Uniform LLC Act* and the *Delaware LLC Act*, voluntary withdrawal is limited. Under most LLC acts, when a death occurs, unless all of the remaining members elect to continue the LLC, it will be dissolved. If the remaining members wish to continue the LLC, then the withdrawing member is entitled to "fair value."

[n] *Arizona*

The *Arizona* LLC Act has language in it which attempts to protect discounts. This Act permits any member of the LLC to withdraw upon written notice. A withdrawal would trigger the dissolution unless the remaining members elect to continue. If the remaining members elect to continue, then the withdrawing party will receive "the fair value of his interest in the LLC as of the date of withdrawal based on his right to share *in reasonably anticipated future distributions from the continuing limited liability company....*" The Act makes it clear (unlike California) that this is the going concern value.

The *Arizona* LLC Act also creates a "family controlled limited liability company." This is defined as an LLC where immediately before the event of withdrawal, the family of the withdrawn family member controls the entity. In the case of a family controlled LLC, the distributions to which the withdrawn family member is entitled in the absence of a provision to the contrary, are the lesser of the liquidation value or the share of the reasonably anticipated

future distributions for 25 years. In short, there is the right to withdraw, but subject to a discount.

Some LLC acts also permit a majority in interest of the members to reinstate the LLC (instead of all) after a withdrawal. This should also help preserve the discount.

Under the *California* LLC Statute (*before the recent changes*) the fallback position allowed a member to withdraw on six months notice and receive "fair value" based on his or her right to receive distributions. Furthermore, the LLC dissolved on the death or withdrawal of a member unless all of the remaining members agree to continue the entity. Finally, a majority of the members were able to compel a dissolution.[176]

A discount should still have been available to members in a *California* LLC (*before the recent changes*). The withdrawal or death did not automatically cause liquidation and the withdrawing member received an amount equal to the member's right to share in distributions if *all* of the other members wished to continue the entity. What is the right to share in distributions? Is this a going concern value? Is the discount the same as for limited partnerships? Put yourself in the shoes of that willing buyer. He or she is not certain of a liquidation value. But, assuming he or she is a person who looks at the extent of the risk, he or she will realize that there is only a need for one negative vote to block the continuation of the entity. The discount was alive but it was less than for partnerships. How much was the discount reduced? It is arguable that the willing buyer was unlikely to have had a lot of confidence in the ability to swing the vote and the discount was still significant.

There has been recent California legislation passed to improve the LLC fallback position in this state. The California legislature recently enacted S.B. 141 which will encourage estate planners to create family LLCs. The effective date of this provision is June 6, 1996. Under the old LLC law, any member of the LLC could withdraw and receive fair value for his or her membership interest. Furthermore, the withdrawal of any member would have constituted a dissolution unless 100% of the remaining members voted to continue the entity. S.B. 141 provides as follows:

> "17252(a) - The articles of organization or a written operating agreement may provide that a member may withdraw, resign, or retire from a limited liability company at the time or upon the happening of events specified in the operating agreement or that the member shall not have the right to withdraw, resign, or retire as a member of a limited liability company. Notwithstanding any restriction upon the right of a member to withdraw, resign, or retire, a member may withdraw from a limited liability company at any time by giving written notice to the other members. However, unless the articles of organization or written operating agreement provide otherwise, the withdrawn member shall not be entitled to payment for the member's interest in the limited liability company and beginning on the date of withdrawal, the withdrawn member shall only have the right of a holder of an economic interest with respect to that withdrawn member's

[176] Cal. Corp. Code § 17350(c).

> interest in the limited liability company and then only with respect to distributions, if any, to which a holder of an economic interest is entitled under the operating agreement of the limited liability company, and the withdrawn member shall no longer be a member of the limited liability company."

This arguably brings the California LLC statute into line with the partnership statute for the allowance of discounts. Although the statute also allows for the imposition of damages on the member who exercises a power of withdrawal, this should not increase the discount because this would probably be an applicable restriction.

Corporations Code § 17350 has also been amended to enhance lack of control discounts as follows:

> "A limited liability company shall be dissolved and its affairs shall be wound up upon the happening of the first to occur of the following:
>
> (a) At the time specified in the articles of organization.
>
> (b) Upon the happening of events specified in the articles of organization or a written operating agreement.
>
> (c) By the vote of a majority in interest of the members or a greater percentage of the voting interests of members as may be specified in the articles of organization or a written operating agreement.
>
> (d) Except as otherwise provided in the articles of organization or a written operating agreement, upon the death, bankruptcy, retirement, resignation, expulsion, or dissolution of any member who is a manager (in the case of a limited liability company managed by one or more managers who are members), or any member (in the case of a limited liability company managed by its members or by one or more managers who are not members) unless, in either case, the business of the limited liability company is continued by a vote of a majority in interest of the remaining members within 90 days of the happening of the event. Notwithstanding anything to the contrary in subdivision (v) of Section 17001 or 17103, the term 'majority in interest of the remaining members' as used in this subdivision shall mean a majority of the profits interests of all of the remaining members and also a majority of the capital interests owned by all of the remaining members.
>
> (e) Entry of a decree of judicial dissolution pursuant to Section 17351."

The new provisions provide a greater likelihood that the business of a family LLC will be continued after the death or withdrawal of a member in that now only a majority in interest of the remaining members must vote to continue the entity within 90 days.

If one looks at family LLCs, (under the new law) there are both manager-managed entities and member-managed entities. If the entity is manager-managed, and the member whose interest is being valued is a minority non-managing interest, there will be a minority interest and marketability discount and the new provisions will have increased the size of the lack of control discount. The minority member may withdraw from the entity but without receiving anything for his or her interest.

What about the majority interest member? In an entity that is managed by all of its members, the majority interest member would not be entitled to any lack of control discount. He or she may dissolve the entity and there will be no marketability discount (but see the discussions below). The same argument will apply to a manager-managed family LLC because of the ability of the majority interest member to dissolve the entity.

[o] *LLC vs. Partnerships*

The above analysis would seem to suggest that family limited partnerships still have an advantage over LLCs for valuation purposes. More particularly, it is possible to create a family limited partnership where the general partners are both the children and the parents and where the parents still maintain ownership of the lion's share of the limited partnership interest (unless you make the argument that the parent may replace the general partner and then liquidate the entity). At the time of the parent's death, the parent would be unable to liquidate the entity. The parent would also not have control of the entity. The fallback position under the LLC statute is less onerous. All that is required is a majority in interest to liquidate the entity. Therefore, if the parent maintains a majority of interest in the LLC at the time of death, it would seem that there would be no minority interest discount nor perhaps a marketability interest discount.

It is important, however, to keep the IRC Section 2704(b) argument in perspective. The first issue is that the Section has been out there for some time and there are no cases where the IRS has relied on this Section. The IRS seems reluctant to try and develop this argument against discounts. Perhaps, they are of the view that they get more mileage out of the uncertainty arising from the Section than from the Section itself.

The latest court cases seem to suggest that there is another way of interpreting the whole issue. The willing buyer would not be a partner and would receive an assignee interest in the entity. He or she would not be able to liquidate the entity because he would not be a member or a partner. Some of the latest cases seem to support this argument. In the case of *Lucile Marie McCormick v. Commissioner*,[177] there was a general partnership interest that was gifted and the court held that there would be no aggregation of the 23 gifts of general partnership interest that were gifted and gave a combined discount of 40.76%. Similarly in the case of *Gordon B.*

[177] 70 T.C. Memo (CCH) 318 (1995).

McClendon Estate v. Commissioner,[178] the court looked at Texas law in valuing the partnership. The court stated that under Texas law where a partner attempts to transfer an interest in a general partnership without consent, the transferred interest is an assignee interest and is limited to the non-controlled right to receive distribution. The IRS tried to argue that the taxpayers son who was one of the partners, who served as attorney-in-fact for the taxpayer and who was the trustee of the family trust and the personal representative of the grandparent's estate, would have consented, and the court specifically rejected this saying that one cannot imply consent to the willing buyer. If this analysis is correct, then the entire debate relating to the fallback position referred to above will become academic. While prudent practitioners will continue to draft their agreements in a manner that gives them the strongest argument in an audit, a final determination of this issue will be made by the courts and the jury is still out. See also *Estate of Barudin*, T.C.M. 1996-395 and *Estate of V.M. McFarland*, T.C.M. 1996-424.

Dennis W. Reilly has written a good article, (*The Valuation Wars — A Change in IRS Battle Strategy*?),[179] where the author tries to predict the battle lines between the IRS and the taxpayers and lists nine areas of concern, including:

- What assets are in the entity;
- How the entity is structured (who is the general partner);
- The size of the discounts;
- Timing;
- Financial conduct (what distributions are made);
- Managerial conduct (formalities that are followed);
- How the agreement is structured (who can sign);
- Use of proper appraisers in calculating contributions;
- Use of independent counsel used by parties.

All these items are clearly features which the taxpayer would be advised to take note of. Perhaps the most important lesson is the old rule of the difference between pigs and hogs — hogs get slaughtered — be a pig.

The Service has yet to win a significant victory in the valuation discount area. Some writers predict that this is the partnership debacle of the 90s. The jury is out, and, in the meantime, the taxpayers are enjoying the fruits.

§ 1.11 WEALTH TRANSFER CONSIDERATIONS

Any gifting program should be based on a desire to benefit one's heirs. This includes the desire to see donees enjoy the gift; to see heirs educated and develop new skills; to help heirs develop a business or an assets base; and provide needed support to the heirs as well as reducing the burden of managing assets for the donor. A gift also protects assets of the donor from creditors. If gifted into trust, assets can be protected from the heirs creditors. Many donors do not want to give up the use of assets or they fear that they may have remorse soon after making

[178] TC Memo, 1996 - 307.

[179] *California Trusts and Estates Quarterly*, Volume 1, Number 3, 1996, page 35.

the gift. Donors are concerned with how the gifts are used. Other donors fear spoiling the donees. Often donors are wealthy but illiquid or fear illiquidity. Lifetime tax planning objectives are motivated to reduce net transfer tax liability. The gift tax rate is generally much lower than the estate tax rate. Income tax planning will create income tax saving by shifting income to the donees.[180] Sometimes the donee pays the same or less than the donor. This does not work if the donee is under 14.[181]

§ 1.12 DIRECT GIFTS

Direct gifts begin with the annual gift. There usually is annual gifting to beneficiaries utilizing the full available annual gift ($10,000 and to increase annually beginning in 1999). This does not require a gift tax return but the statute does not run either.[182] After that it extends to gifting the unified credit amount. Sometimes gifts will be even larger and require a gift tax.[183] Normally small gifts are made outright and larger gifts in some type of trust or corporate entity.[184] In a typical transaction donor (i.e., parent) makes an outright gift to a donee (i.e., child). Gifts in trust, in order to qualify for the gift tax exclusion, must be to a qualified trust[185] or a trust that utilizes the so-called *Crummey* withdrawal power. A tax return must be filed for gifts over the annual gift amount.[186] The gift tax is due even if an extension has been filed.[187] The Administration has recently proposed the repeal of the *Crummey* withdrawal powers.

[1] Use of Discounting

As with any type of gifting program, the selection of the asset is critical. It is viewed that gifting cash should be used because of the ease of transfer and valuation. However, the inability to leverage or discount cash lessens the value of a gift of cash. Rather, the use of an asset with some type of discount (i.e., minority or marketability privately held stock) is highly desirable. The statute of limitations for assessing gift tax is normally three years after the return is filed but six years if it exceeds 25 percent of the total gifts which discounting can cause.[188] Discounts can be created by subdividing gifts between donees or by making incremental gifts over different periods. Other discounts can be created by wisely selecting assets to be gifted. If the asset is low in value and highly likely to appreciate, the donors can take advantage of the low value at the time of the gift.

[2] Advantages of Gifting

The tax advantages of gifts are obvious. The estate is reduced. Income from the asset is shifted to the donees and future appreciation is out of the donor's estate. Use of the annual

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180 IRC Section 2035(c).
181 IRC Section 1(g).
182 IRS Section 6019.
183 IRC Section 2504(c) and Treas. Reg. Section 25.2513-1(c).
184 IRC Section 2503(b).
185 IRC Section 2503(c)
186 IRC Section 6075(b).
187 IRC Section 6151(a).
188 IRC Sections 6501(a), 6501(b)(1).

exclusion reduces the need to use up valuable lifetime credits. Including grandchildren or other lower generation beneficiaries in any type of gifting program will create a situation where more assets can be removed from the estate because you have more annual exclusions to use. Donors often want to see donees have the enjoyment of assets while they are still alive. The donees can use the assets for education, housing or just to have fun. The purpose of the gift may be tax reduction but the donor enjoys seeing the donees spend or invest the gift. If one spouse makes a gift, he or she can elect gift splitting to maximize the gifting.[189]

If the gift was not made, the assets would still be in the donors' estate at death and taxed at the same rate of up to 55%.[190] If gift tax is paid and the donor lives more than three years after the gift it will not be added back to the estate.[191] In other words, the gift tax is tax-exclusive, and the estate tax is tax-inclusive.[192] The maximum gift tax rate is only 35% versus 55%.

[3] Disadvantages of Gifting

By making an outright gift the donor loses the asset, its cash flow and any control over the use of the gifts. The donor must pay the gift tax, not the donee. Another major tax disadvantage of any lifetime gifting program is that gifts carry over the basis and there is no step up in basis under IRC Section 1014 which can be received at the time of death. If death is near, the probable loss of increase basis should be evaluated versus the advantages of gifting. Once gifted the donee will have to pay any capital gain the donor would have paid. An asset gifted will not receive a basis adjustment. However, some gifts may be included in the donor's estate if he dies within three years after the gift is made.[193] This usually arises with life insurance.[194]

Gifts to trusts will qualify for the annual exclusion when coupled with crummey provisions. These powers were expanded greatly in the *Crisofani* case which allowed gift tax annual exclusions based on withdrawal rights given to contingent remainder beneficiaries of a trust.[195] The IRS has continued its assault on abusive crummey trusts.[196] In addition, gift tax paid by the donor on a gift within three years of his death is included in his estate.[197] If the property declines, the technique does not work. Finally, what if the gift tax is paid and the law changes and become more favorable.

[4] Example

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189 IRC Section 2513. See also Rev. Rul. 54-246, 1954-1 CB 179.

190 IRC Sections 2001, 2502

191 IRC Section 2035(c) and TAM 972.9005 (July 18, 1997).

192 IRC Sections 2501, 2001

193 See Sections 2036, 2037, 2038 or Section 2042.

194 IRC Sections 2035(d)(4), 2042.

195 *Estate of Cristofani v. Comm'r.*, 97 T.C. 74 (1991).

196 *Estate of Kohlsaat v. Comm'r.*, 73 T.C.M 2732 (1997) and *Estate of Holland v. Comm'r.*, 73 T.C.M. 3236 (1997).

197 IRC Section 2035(c).

Parents wish to make an outright gift to their children of an entire asset (a family home) and they are willing to use their annual exclusion and part of their unified credit. If H gives away a $1,000,000 home which is discounted (because it is gifted incrementally over time) to $700,000 to son A and B and the property appreciates in value to $2,000,000 by the time of H's death, and produces $1,000,000 of after tax income. The $1,300,000 increase in value is not subject to estate tax as H no longer owned the assets at his death and the $1,000,000 of after tax income is not subject to estate tax. The gift saves $1,650,000 in estate taxes (55% x $3,000,000). Parents would be better suited to make separate gifts to each child in two successive calendar years and take advantage of any minority and fractional interest discount. However, remember there is not a step up in basis on the gift.

§ 1.13 QUALIFIED PERSONAL RESIDENCE TRUST

A Qualified Personal Residence Trust ("QPRT") is a technique which enables a person to transfer a personal residence, including a vacation home to younger beneficiaries at a significantly reduced transfer tax cost and retain the right to live in the residence for a specified period.[198] It has become one of the best transfer methods available to the estate planner. The Grantor transfers at a fraction of the cost a personal residence or vacation home to an irrevocable trust and reserves the right to live in the residence, rent-free, for a specified term. There are numerous requirements to make the transfer effective.[199]

[1] Discounting

Use of discounting techniques will create the ability to gift more or use less unified credit. Separate gifts by spouses to different beneficiaries into QPRTs over different periods will increase the amount of discounting. By gifting a fraction of the house, a minority and lack of marketability discount can be used.[200] Even the IRS table provide a discount based on the term of years.[201]

[2] Advantages of a QPRT

The value of the gift is equal to the value of the remainder interest. In addition, the value of the gift is further reduced if the Grantor retains a contingent reversionary interest (i.e., the residence reverts to the Grantor's estate or living trust if the Grantor doesn't survive the term).[202] The amount of the taxable gift is computed based on the equity in the residence at the time of the transfer. If the Grantor survives the term, all subsequent appreciation is removed from the Grantor's estate.

Unlike discounts based upon lack of marketability and minority interest discounts, which are subject to IRS attack, the discounts obtained by QPRTs are determined by using actuarial tables published by the IRS. The rental payments paid by the Grantor after the end of the trust

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198 See IRC Section 2702 and regulations.

199 Treas. Reg. Section 25.2702.5(c).

200 See Section 1.5 above.

201 See IRS Publication 1457 and 1458, Alpha and Beta Volume.

202 There is no additional estate tax consequences for the contingent reversion.

term results in cash transfers being made to family members which are not applied against the Grantor's gift tax annual exclusion or unified credit amount and if properly drafted the payments are not taxed as rental income to the family members.

A personal residence may provide substantial creditor protection for trust assets. However, the Grantor should be willing to allow someone else to be the trustee if this is desired, otherwise the donor can be the trustee.[203] At the end of the term, the formal right of the Grantor to use the property ceases and the beneficial ownership is gone. The annual exclusion or GST exemption does not qualify and the agreement is more complicated than an outright gift.

By creating separate trusts for each spouse, one-half of the gift and estate tax benefits of half of the QPRTs can still be preserved if one spouse does not survive the term of his or her trust. Grantors want assurance that he or she will be able to live in the residence (or a replacement residence) for the Grantor's entire lifetime. A QPRT may provide that any sale proceeds not reinvested in a new residence be distributed to the Grantor. However, from an estate tax standpoint, it is more advantageous to let the excess proceeds remain in the trust. After the expiration of the Grantor's interest in the trust, the Grantor may no longer be the Trustee, therefore, it may be desirable to provide for an independent person to be a "Trust Protector" with the power to remove a Trustee. The longer the QPRT term, the lower the value of the gift will be. The risk of not surviving the term can be lessened through the following alternatives. Married couples can transfer the residence to a QPRT created by the younger or healthier spouse. Purchasing life insurance on the Grantor's life can protect against the event of the Grantor's death before the end of the trust term.

[3] Disadvantage of a QPRT

The principal risk is that the donor dies during the term of the QPRT. In that instant the asset will be included in his estate.[204] This risk can be reduced by reducing the term of the QPRT. Of course, this reduces the value and the amount of discount allowed. A hedge might be to purchase short term life insurance for the term of the QPRT thereby avoiding any downside problem.

Most of the reduction occurs in the first few years and the higher the 7520 rates the greater the discount.[205] However, the donor decides when to make the gift, thereby choosing the 7520 rate. Waiting can cause the value of the residence to increase and thereby reduce the value of the high 7520 rate.

In addition, a gift to a QPRT will not qualify for the annual exclusion, since the remainder interest is not a present interest. A gift tax return will need to be filed.

If the donor moves during the term, certain disadvantages can occur. Its primary use must be a residence[206], but it can have a home office.[207] Also, it cannot include personal

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203 IRC Section 2036(c).

204 IRC Section 2036(a)(1).

205 IRC Section 7520.

206 Treas. Reg. Sections 25.2702-5(b)(2)(iii), 25.2702-5(c)(2)(iii).

property.[208] If there is a mortgage and the donor pays the mortgage, this will be considered an additional gift or loan.[209] If it no longer is a residence, the donor has two years after the sale to repurchase.[210] Otherwise, the asset becomes a GRAT.[211]

The other concern is the house is gone at the end of the term. The donor becomes homeless. The normal plan is for the donor to rent the home if both parties can agree with the terms.[212] Another disadvantage is there is no step up in basis.

[4] Example

Assume H&W transfers a residence worth $500,000 to a QPRT for 15 years for the benefit of his children. Assuming a 9% 7520 rate the discount would be 77%. If the term is 5 years, the discount would only be 37%. If the house is gifted to various children in separate QPRTs by H&W, a fractional interest discount would be allowed.

§ 1.14 GRANTOR RETAINED ANNUITY TRUST

A Grantor Retained Annuity Trust ("GRAT") is a technique which enables a person to transfer property to younger family members at a significantly reduced transfer tax cost while retaining an income interest for a specified period of time.[213] The Grantor transfers investment assets to an irrevocable trust and reserves the right to receive annual annuity distributions from the trust for a specified term selected by the Grantor. The annuity payment is smaller if payments are more frequently than annually. After the specified term of years has expired the property is distributed to, or held in trust for, the beneficiaries. The structure of a GRAT is similar to a charitable lead trust.[214]

[1] Use of Discounting

Discounting increases the savings significantly because the initial value is decreased therefore the payout is decreased. If the annuity is high enough, the term long enough, and discount great enough, there will be little gift tax. Discounting can be created by fractionalizing the gift or structuring it within an entity with restrictions upon transferability. A growth rate can be miraculously increased with discounting.[215] Unlike discounts based upon lack of marketability and minority interest discounts, which are subject to IRS attack, the discounts obtained by GRATs are determined by using actuarial tables published by the IRS. If the IRS revalues the asset, the annuity payout self adjusts and does not affect the gift tax return.

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207 PLR 9609015 (Nov. 22, 1995).
208 Treas. Reg. Sections 25.2702-5(b)(ii), 25.2702-5(c)((2)(ii).
209 Treas. Reg. Sections 25.2702-5(2)(ii), 25.2702-5(c)(ii).
210 Treas. Reg. Section 25.2702-5(c)(8)(i).
211 Treas. Reg. Section 25.2702-5(c)(7)(ii).
212 PLR 9441039 (July 15, 1994).
213 IRS Sections 2702(a)(2)(b), 2702(b).
214 These are discussed in Section 1.20.
215 Priv.Ltr.Rul. 970727.

[2] Advantages of GRATs

A Grantor can retain control of assets gifted. During the trust term, the Grantor can be the Trustee and therefore maintain control over the investment of trust assets and voting power with regard to any partnership interest or stock held in the trust. The Trust is considered a Grantor Trust.[216] All gains and losses are reported by the Grantor during the term. During the trust term (which is selected by the Grantor), the Grantor receives annual annuity distributions which are determined by the Grantor at the time the GRAT is created. The value of the gift is equal to the value of the remainder interest. The amount of the discount primarily depends upon the length of the trust term and the annuity rate retained by the Grantor. If the Grantor survives the term, all subsequent appreciation in value avoids gift and estate tax. As long as it is a grantor trust, the GRAT can hold S Corporation stock.[217]

If the Grantor does not survive the term of the trust, the IRS takes the position that the entire value of the asset is included in the Grantor's estate. If the Grantor does not survive the term, the portion of the Grantor's unified credit equivalent that was used when the initial transferal was made is restored. If the annuity is stated in a fraction, the trust will adjust if the initial amount of payment is incorrect.[218]

[3] Disadvantages of GRATS

The GRAT requires the gift be valued using an assumed rate of return of 120% of the applicable federal rate. A grantor retained unitrust (GRUT) can be used but this would not be an effective freeze.[219]

If the grantor dies during the term all the trust property will be included in his estate. If this occurs, the grantor has lost the opportunity to do other estate planning. In other words, the income cannot be assigned to another.[220] The longer the term, the less the gift but the more likely the GRAT will fail.

The basis of the property transferred to family members at the end of the trust term is the Grantor's basis *(i.e.,* the asset does not get a step-up in basis at the Grantor's death). Transfers to GRATs do not qualify for the annual gift tax exclusion. Special rules prevent the Grantor from allocating the Grantor's $1,000,000 GST tax exemption to a GRAT until the expiration of the trust term because for generation-skipping transfer tax purposes, the transfer is deemed to occur immediately prior to its termination.[221]

Income in excess of the annuity can pass to the holder of the annuity but this would increase not decrease his estate.[222] Also, payment by a loan could disqualify the trust.[223]

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216 IRC Sections 673, 677.
217 IRC Section 1361(c)(20(A).
218 Treas. Reg. Section 252702-3(b)(2).
219 Treas. Reg. Section 252702-3(c).
220 Treas. Reg. Section 252702-3(d)(2).
221 Treas. Reg. Section 262732-1(c)(4).
222 Treas. Reg. Section 252702-3(b)(1)(iii).

Although payment in kind would be available[224] additional contributions are not allowed.[225] So if the grantor wants to make additional gifts, another GRAT must be created. The trust cannot be paid off early.[226]

[4] Increasing Annuity Pay-Out "Ramp Up"

A GRAT may provide that the annuity amount be increased each year by a stated amount or percentage which is not in excess of 120% of the annuity amount paid in the preceding year.[227] If the trust provides for such an increase, the value of the retained interest will be increased, decreasing the amount of the gift. The annuity can increase up to 20% per year. This can be more beneficial because the trust will have more time to accumulate in the earlier years.

[5] Examples

An 8% interest retained by the Grantor at age 60 for 15 years in a GRAT results in only 31% of the contribution to the trust being considered a gift. A 5% interest retained by a Grantor at age 60 for 15 years in a GRAT results in only 57% of the contribution to the trust being considered a gift. An 10% interest retained by a Grantor at age 60 for 15 years in a GRAT results in only 14% of the contributions to the trust being considered a gift. If the stock does not go up in value, the grantor gets the asset back and only the opportunity is lost.

For example, the contribution of a $500,000 asset to a 15 year GRAT by a 60 year old with an 10% payout rate will create a 86% discount. However, the effective discount could be increased if a discount could be taken at the front end using one of the methods discussed earlier in this outline. However, if the return after all discounts is less than the 7520 rate an outright gift would be better than a GRAT.

§ 1.15 SALES

A sale of appreciating assets to younger generation family members may allow larger assets to pass to the younger generation without a gift tax or allow the younger generation to feel as if he was not given a break. The sale substitutes cash or promissory notes for the appreciating asset. If the asset increases at a greater rate than the interest paid, there is an effective freeze.

[1] Use of Discounting

An outright sale will create no minority discount and may carry a control premium. But selling assets in small increments should create discounting advantages and avoid a premium charge. A concern will be that the IRS views such a sale as a bargain sale and therefore a partial gift. It may be used to make a gift in the year of a sale with an aggressive price to start the statute running.

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223 Tech.Adv.Mem.9604005 (October 17, 1995).
224 Rev. Rul. 85-13, 1985-1 CB 184.
225 Tech. Adv. Mem. 9604005 (October 17, 1995).
226 Treas. Reg. Section 252702-3(d)(4).
227 Treas. Reg. Section 252702-3(b)(1)(ii).

[2] Advantages and Disadvantages of a Sale

The owner of real estate or business interests could sell the property to his children or to trusts for their benefit at the low end of the range of reasonable values without having made a taxable gift. The purchaser receives a new basis for income tax purposes equal to the purchase price and realizes gain on a subsequent resale only to the extent the resale price exceeded the purchase price. Besides future appreciation being removed, the seller will create liquidity for himself. Making business or investment opportunities available to younger generation beneficiaries (or trusts for their benefit), which do not involve transferring property or property interests, are not transfers recognized by the transfer tax system. It will not work for depreciable property[228] sold to a related person.[229]

[3] Tax Consequences

The gift or cancellation of an installment note requires the seller to recognize all of the deferred gain. The bequest of the note at death to the buyer (beneficiary) is similarly treated as a disposition by the seller's estate, triggering recognition of the balance of the note by the estate.

If the buyer is in a higher bracket, the sale may create depreciation which will lower his taxes. On the other hand, the seller has capital gains, loses control and has cash in place of the asset. The note must bear interest at a fixed rate or at a rate which bears a fixed relationship to a specified market interest rate.

[4] Examples

Father sells a piece of land to son for $500,000 with a $400,000 loan. If the loan is lower than the appropriate interest rate, there will be a gift. Father wants to sell company to son. Company is valued at $2,000,000. However, by selling the company in increments, various discounts come into play and substantial savings can be realized. Son buys the company at a premium with 20% down and a note for 12 years. Father dies in 6 years and the remainder of the note has to be paid unless it has a self-canceling feature.

§ 1.16 SALE TO A DEFECTIVE GRANTOR TRUST

An installment sale to a Grantor Trust forces the Grantor to pay the income taxes on any gains or earnings. This technique looks similar to a Grantor Retained Annuity Trust ("GRAT") but can generate more favorable transfer tax benefits. First, the Grantor creates and makes a gift to an irrevocable trust established for the benefit of the Grantor's descendants. The trust will be structured to be excluded from the Grantor's estate for estate tax purposes, but will be considered to be "owned" by the Grantor for income tax purposes. This is accomplished by intentionally violating one or more of the so-called grantor trust rules under the tax code, so that both the ordinary income and capital gain of the trust are taxed to the Grantor.

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228 IRC Section 453(g)(1).

229 IRC Section 453(g)(3).

Second, the Grantor subsequently would sell assets to the trust in exchange for a down payment and a promissory note from the trust for the balance.[230] The note could be payable in installments, or could accrue interest and be payable in a balloon at the end of the selected note term. In either case, no tax is due.[231]

[1] Use of Discounting

Discounting can lower the sales price which in turn will lower the note. The benefits of discounting are similar to that of a sale. The more the discounts, the less the sale value the less the note and therefore the less the estate tax.

[2] Tax Effects

The IRS currently takes the position that the existence of a defective grantor trust is disregarded for income tax purposes, and that the sale transaction described above between the Grantor and the trust has no income tax consequences.

The Grantor's death could trigger a capital gains tax on the purchased interest that would be payable by the estate.[232] Whether this result occurs is somewhat uncertain, as there is no clear legal authority. Because this technique is relatively new and has not been tested in a reported court case or reviewed in a public ruling by the IRS, there is also an additional risk that the IRS could try to include the transferred assets in the Grantor's estate in any event under one or more possible legal theories.

At the end of the note term, the trust will own the purchased assets free and clear, with no further transfer tax consequences. The Grantor will in effect have received back from the trust the initial sale price plus statutory interest. In addition, each year the Grantor will pay the income taxes on whatever income is earned by the trust on its assets, even though all or part of that income is not payable as interest to the Grantor. This represents an effective tax-free gift to the trust, which will be left with more total value than if the trust paid its own taxes.

[3] Advantages and Disadvantages

The trust will own all of the appreciation on the purchased interest in excess of the statutory interest amount. If the asset sold had a discounted value, but the note payments are made with cash or other nondiscounted assets, the trust also receives the benefit of the discount without transfer tax. Only the unpaid principal on the note will be included in the Grantor's estate. Unlike a GRAT, this transaction should be beneficial even if the Grantor does not survive the note term. Only the remaining unpaid principal value of the note (plus payments received) would be included in the grantor's estate. GST exemption can be used on the entire purchase other than the downpayment.

[230] Rev. Rul. 85013, 1985-1 CB 184.

[231] See *Rothstein v. United States*, 735 F2d 704 (2d Cir. 1984).

[232] See *Madorin v. Commissioner*, 84 TC 667 (1985) or Rev. Rul. TI-402, 1977.

[4] Example

Grantor owns an asset with a low basis of $100,000 and current value of $1,500,000. Grantor creates a trust and gives the trustee the power to distribute income to his children and his spouse and makes a gift of $150,000. Grantor gifts half to his spouse and the two sell 12½% to an intentionally defective trust for each of their 4 children. The appraiser appraises the 12½% interest with a 33% discount. The trust buys the assets with the cash and a note at the applicable rate. Under current IRS rules there is no gain on the sale and the asset is frozen in value except for the interest payments.

§ 1.17 PRIVATE ANNUITIES

Private annuity transactions may be used to shift post transfer appreciation within the family group. Private annuity transactions usually occur between an elderly parent and an adult child and are entered into in order to remove property from the parent's estate while allowing the parent to retain the economic equivalent of a life estate in the transferred property. A private annuity involves the transfer by an individual annuitant of cash or other assets to a transferee not in the business of selling annuities in exchange for the transferee's unsecured promise to pay an annuity to the annuitant for the remainder of his life.

[1] Use of Discounts

All forms of discounting can be used to lower the assets transferred and therefore the annuity payout amount. Grantor may want to have a series of annuities to take advantage of minority discounting.

[2] Advantages and Disadvantages of a Private Annuity

To some degree, a private annuity resembles an installment sale while avoiding the drawback of immediately reporting gain. For example, the installment method is unavailable for the sale of publicly traded securities. Such securities may be transferred in exchange for a private annuity. If the asset grows faster than the 7520 rate, it will be an effective technique. It also works when the annuitant has a shorter life expectancy than the tables.

The private annuity, however, has several drawbacks. The transferee's obligation to pay the annuity amount must be unsecured.[233] If the annuity amount is made from the asset transferred, or effectively connected to such asset, the Internal Revenue Service will contend that the transferor retained an interest in the property which will make IRC Section 2036 applicable.[234] No portion of the annuity payments may be treated as interest by the transferee.

If the transferred property is sold while the annuitant is living and the annuitant dies before having received total annuity payments equal to the present value of the annuity payments

[233] *Bell v. Comm.*, 60 TC 469 (1973).

[234] (See *212 Corp. v. Comm.*, 70 TC 788 (1978).)

used to compute the transferee's basis in the property, the transferee will recognize taxable gain.[235] A formula is used to determine how much is principal or gain.[236]

If the annuitant outlives his estimated life expectancy, total annuity payments may well exceed the estate tax savings arising from the annuity transaction. The purchaser must be able to make the payments.[237] If the annuitant has a 50% chance of not living a year, the tables cannot be used.[238]

[3] Example

Annuitant, age 65, transfers $2,000,000 of the family business to two children in exchange for a promise by children to pay $50,000 a year for life. If annuitant dies after 5 years after receiving $250,000 there will be substantial estate tax savings. However, if the annuitant outlived his life expectancy, the payments would create a larger estate for him than had he not done it.

§ 1.18 PARTNERSHIP FREEZE

A frozen partnership creates multiple types of partnership interests. A frozen (preferred) interest is given a guaranteed annual payment and a priority claim on liquidation.[239] This is done by creating a partnership with two basic types of interests, (i) those that have a fixed value but a preferred cash flow ("frozen interest"), and (ii) those that share all future appreciation ("growth interest").

[1] Discounting

Besides the advantages of the partnership itself, discounting will create additional savings by lowering the payout required of the frozen interest. The excess income will pass to the growth interest (lower generation).

[2] Advantages and Disadvantages

Gifts to beneficiaries would be made with growth interests while interests retained would be frozen interests. The parents can retain some growth interests as well if desired. If the parents remain as general partners, they will maintain management control.

Partially offsetting the benefit to the parents of this shift in appreciation is the fact that they are receiving annual preferred income payments, which will increase their estate. In addition, the growth partners are giving up most of the current return on their investment in the partnership, at least in the initial years, in order to satisfy the preferred income payments to the

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235 Rev. Rul 55-119 (1985-1) CB 352.
236 IRC Section 72.
237 *Estate of Mitchell v. Comm.*, 1982 PH TC Memo.
238 Treas. Reg. Section 207520-3(b)(i).
239 (See IRC Section 2701(c).)

frozen partners. These include retained management control, restrictions on transfer or partnership interests, and discounts when partnership interests are transferred.

First, in any family partnership, the general partners cannot directly retain control over the limited partnership interests issued to other family members. Otherwise, there is a risk that the growth partners may not be treated as "partners" for tax purposes. The general partners should only retain control over the business affairs of the partnership, and should not retain controls which restrict the growth partners' right to transfer or liquidate their interests to any greater degree than would ordinarily apply to unrelated limited partners in a normal business relationship. This will still permit restrictions on transfer and will permit the parents to control cash flow to the children.

A second potential tax problem arises if the frozen partnership interests are actually worth less than the stated value assigned to them when the partnership was created. This would mean a frozen partner's interest would be worth less than what was contributed to the partnership and the frozen partner would be treated as having made a made a gift to the growth partners.

§ 1.19 CHARITABLE REMAINDER UNITRUSTS ("CRUT")

An estate planning technique which enables a person to (i) obtain an immediate income tax deduction, (ii) retain an annual income for life (or, for the lives of others), (iii) avoid a tax on the sale of capital assets (e.g. stock or real property) and (iv) reduce one's taxable estate.[240] The Grantor transfers low basis, low yielding assets into an irrevocable tax exempt trust and reserve for his lifetime (or a period of years) an annual income based upon a selected percentage of the fair market value of the trust property.[241] Grantor receives a charitable income tax deduction and the trust can sell the asset and pay no immediate gain.

[1] Use of Discounting

Discounting at inception will decrease the amount of charitable deduction and the initial payout; however, the income should stay the same. As income accumulates, the payout will grow.

[2] Advantages and Disadvantages of a CRUT

The major disadvantage of establishing a CRUT is the loss of the trust principal to charity in the event of the early deaths of the income beneficiaries.[242] The typical solution involves the purchase of life insurance to replace the family wealth which may be lost in the event of early deaths. Another disadvantage is the application of the private foundation rules and the problems with unrelated business taxable income.[243]

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240 (See IRC Sections 664(d), 2055(e) and 2522(c).)

241 Treas. Reg. Section 1.664-2(a)(5)(i).

242 IRC Section 664(d)(1).

243 Treas. Reg. 1.664-1(c).

The advantages of a CRT include an income tax charitable deduction on the transfer[244] tax free sale of property by the trust[245] tax free accumulation of income and deferral of taxation until actually received.[246]

[3] Example

A Grantor, age 55, in anticipation of a sale, but prior to a letter of intent transfers $500,000 of property (e.g., a portion of stock of his business) to a CRUT reserving for his lifetime an annual return equal to 8% of the value of the trust property. Thereafter, the property is sold; and no tax is paid on the sale. The result would be as follows: The Grantor would receive an immediate income tax deduction of approximately $100,000. The Grantor would receive an annual payment of $40,000, i.e. 8% of $500.000 (as compared to the return on approximately $350,000 if taxes were paid on the sale). Obviously, if the appraisal took discounts into consideration, the deduction would be lower and the amount of payout would decrease.

§ 1.20 CHARITABLE LEAD TRUSTS

A charitable lead trust ("CLT") is an estate planning technique which enables a person to transfer property to younger family members at a substantially reduced transfer cost while providing a designated amount to be distributed to one or more charitable organizations for a specific number of years.[247] The Grantor transfers property (usually income producing) to an irrevocable trust and designates a charity to receive a specified amount for a term of years. Generally, the amount paid to charity is consistent with the amounts that the Grantor would have paid absent the creation of the trust. After the specified terms of years has expired, the property is distributed to, or held in trust for, the family member beneficiaries.

[1] Use of Discounting

Using discounting techniques will decrease the initial contribution and therefore reduce the payout to charity but more than likely increase the remainder to the beneficiaries. This is because the discounting effects the contribution amount but does not decrease the cash flow.

Valuation discounts applied to assets transferred to a charitable lead trust for minority interests, lack of marketability, etc., reduce the value of the remainder interest dollar for dollar. However, the remainderman may be able to later restructure the asset to eliminate whatever caused the discount.

[2] Advantages and Disadvantages of a CLT

The value of the taxable gift is equal to the value of the remainder interest that is designated to go to family remainder beneficiaries. The amount of the discount primarily

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244 Treas. Reg. Sections 1.664-2(d) and 1.664-3(d).

245 See *Ferguson v. Comm.*, 108 TC No. 14 (April 28, 1997).

246 Treas. Reg. 1.664-1(c).

247 IRC Section 2522(c)(2)(B).

depends upon the trust term, the amount of the income stream designated for the charity and the discounted value of the asset contributed. The amount of the taxable gift is computed based on the value of the property transferred to the lead trust. All subsequent appreciation in value avoids gift and estate tax. For a charitable lead unitrust (as opposed to charitable lead annuity trust) it is only necessary to allocate an amount of the GST exemption amount equal to the value of the remainder interest in the trust that passes to family members.

Unlike discounts based upon marketability and minority interest, which are subject to IRS attack, valuation discounts obtained by charitable lead trusts are determined by using actuarial tables published by the IRS.

A charitable lead trust is particularly appropriate when the client is already making continuing and regular contributions to charity and the beneficiaries are not in need of the assets for a period of time. If an individual is not expected to live to his or her actuarial life expectancy, establishing an inter vivos charitable lead trust that is designed to pass trust corpus to family remainder beneficiaries upon the death of the Grantor may be particularly advantageous.

The use of a charitable lead trust with a family foundation named as a permissible beneficiary of the charitable lead interest can be an effective way to reduce transfer taxation and preserve effective family control over the asset and to some degree the income earned during the lead term.

A charitable lead trust may be used in conjunction with a charitable remainder trust and a life insurance trust to hedge against the possibility of the early death of the donor.

A testamentary charitable lead trust is a lead trust that is created upon the Grantor's death through the Grantor's will or living trust. The value of the property transferred to the lead trust will be included in the Grantor's estate.

[3] Example

Grantor transfers 500,000 of stock to a CLAT for 15 years with a quarterly payout of 11%. Assuming a 7.4% AFR there is a 57% discount. Using one of the discounts discussed above in the valuation of the asset will increase the ultimate distribution by reducing the payout or shortening the payout period.

§ 1.21 CONCLUSION

Too often the practitioner thinks of the sophisticated technique but ignores the smart and safe discount process which should be done in conjunction with such techniques. It has been the continuing trend of the IRS and Congress to limit the use of such tax saving techniques and the use of discounting. No doubt these techniques will continue to change over time. A program of discounting and gifting, sales and loans should be a part of most large estate plans.