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TAX COURT DECISIONS ON FAMILY LIMITED PARTNERSHIPS AID BOTH TAXPAYERS AND IRS

by

Martin H. Zern*

I. INTRODUCTION

In the complex arena of estate and gift taxation, controversies frequently arise between taxpayers and the Internal Revenue Service (IRS) concerning the value of property gifted or owed at death. Since the estate and gift taxes are based upon the valuation of property – determined at the time of death or at the time of the gift – taxpayers generally attempt to minimize values whereas the IRS attempts to maximize them.¹

A sophisticated estate planning structure for minimizing values, or at least endeavoring to do so, is the family limited partnership. Typically, property is transferred to a newly formed limited partnership by a well-to-do taxpayer followed by transfers of partnership interests to children or other family members as gifts. Often, the property transferred to the partnership consists partly or entirely of publicly traded securities for which market values are readily available. The transfer of partnership interests may be outright, to custodial accounts or in trust. A valuation discount for the gifts of the partnership interests is then claimed for their alleged lack of marketability, which is based partly upon restrictions on

transferability contained in the partnership agreement. A further discount is claimed for the fact that the partnership interests gifted are minority interests. Accordingly, the claimed value of the gift is based not upon the value of the publicly traded securities transferred to the partnership, but the allegedly considerably lower value of the partnership interests resulting from minority and marketability discounts. The IRS has attacked the family limited partnership divide over the years with mixed results using a variety of Internal Revenue Code provisions.² It particularly frowns on the transfer of publicly traded securities to a family limited partnership, especially where the creation of the partnership, the transfers of the securities to it and the gifts of the partnership interests occur practically simultaneously. Two Tax Court cases of fairly recent vintage, one decided in 2000 and another in 2004, favored the IRS position. The IRS was less successful, however, in a Tax Court case decided in May of 2008, Hollman v. Commissioner,³ and in a follow up case with similar facts decided in September of 2008, Bianca Gross v. Commissioner.⁴

II. EARLIER TAX COURT DECISIONS FAVORING THE IRS.

A Tax Court decision in 2000, Shepherd v. Commissioner, was affirmed by the Eleventh Circuit in 2002.⁵ In Shepherd, the taxpayer transferred real property and shares of publicly traded stock to a newly-formed limited partnership in which he was a 50% owner and each of his two sons were 25% owners. Rather than allocating the value of the property transferred to the taxpayer’s capital account, the value was allocate, pursuant to the partnership agreement, pr rat based on ownership. Accordingly, 50% was allocated to the taxpayer’s capital account and 25% was allocated to each of the capital accounts of his two sons. The transfer of the property to the

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partnership and the transfers of the interests in the partnership occurred on the same day. The IRS asserted that the transfer of the property to the partnership was an indirect gift of the property itself to the sons and not a gift of the partnership interests (with a claimed discounted value). Because the noncontributing partners’ capital accounts were enhanced by the contribution of the taxpayer, the Tax Court held that the transfers were indirect gifts by the taxpayer to his sons of undivided 25-percent interests in the real property and shares of stock. No discounts were allowed for minority and marketability discounts on the gifts of the partnership interest to the sons.

A Tax Court decision in 2004, Senda v. Commissioner, was affirmed by the Eighth Circuit in 2006. In Senda, the taxpayers transferred shares of publicly traded stock to two family limited partnerships, coupled with transfers of limited partnership interests to their children. As in Shepherd, the transfers took place the same day. The Tax Court found: “At best, the transfers were integrated (as asserted by respondent) and, in effect, simultaneous.” The transfers of the shares of stock to the partnerships were held to be indirect gifts of the shares to the children. Again, no minority and marketability discounts were allowed.

III. HOLLMAN v. COMMISSIONER

The Tax Court decided the Hollman case in May, 2008. The case has stirred up some controversy, but should give aggressive estate and gift tax practitioners some hope of successfully asserting minority and marketability discounts if the estate plan is structured correctly. On the other hand, the discounts allowed probably will not be as much as sought.

A. Facts

The taxpayers, husband and wife, had four minor children. The husband, Thomas Hollman (Tom), was employed by Dell Computer Corp. (Dell) from 1988 through November of 2001. During the course of his employment, Tom received substantial stock options, some of which he exercised. Additionally, he purchased shares of Dell Stock. As the wealth of the taxpayers increased, they became concerned with managing it, particularly as to how it might affect their children. With this in mind, beginning in 1996 and continuing into 1999, they transferred Dell stock to custodial accounts (Under the Texas Uniform Transfers to Minors Act) for each of their three daughters. Tom’s mother (Janelle) ultimately wound up as the custodian after Tom resigned.

In 1997, the taxpayers met with an estate planning attorney who advised them of the gift tax savings from valuation discounts of gifts of limited partnership interests rather than of gifts of the property contributed to the limited partnership. In 1999, following the advice of the attorney, the taxpayers formed an irrevocable trust (the trust), naming themselves as grantors, Janelle as trustee and their children as beneficiaries. The taxpayers executed the trust on September 10, 1999, Janelle executed it on November 4, 1999, and the trust stated it was effective September 10, 1999. One hundred shares of Dell stock and $10,000 were transferred into the trust. The taxpayers also executed a limited partnership agreement on November 2, 1999. Janelle executed it thereafter. On November 2, 1999, Janelle, as trustee, transferred the 100 shares of Dell stock to the limited partnership in exchange for a partnership interest. On the same date, the taxpayers transferred 70,000 shares of Dell stock to the partnership in exchange for partnership interests.
Tom testified that the reason for setting up the family limited partnership was long-term growth, asset protection and preservation. He stated his concern that a direct gift to his children might de-motivate them: "We did not want our daughters to just go blow this money." He also stated he was concerned about protecting the assets from friends, spouses and potential creditors and wanted something to educate his daughters on business matters.

On November 8, 1999, the taxpayers made a gift of limited partnership interests to Janelle, both as custodian under the state’s Uniform Gifts to Minors Act (UGMA) and as trustee. On December 13, 1999, further transfers of Dell stock, in exchange for partnership interests, were made from custodial accounts for the taxpayers’ children set up under UGMA. As a result of the transfers, the trust wound up owning about 49% of the partnership interests, custodial accounts wound up owning about 40% of the partnership interests, and the taxpayers wound up owning general and limited partnership interest comprising the other 11%. Considerably less significant transfers to partnership interests were made in 2001 and 2002.

The limited partnership agreement contained a number of restrictive provisions that the taxpayers claimed affected the value of the partnership interests. The more salient were: (1) restrictions on withdrawing from the partnership, (2) restrictions on assigning partnership interests, (3) a provision requiring unanimous consent of all partners to dissolve the partnership and wind up its affairs, and (4) a reacquisition provision giving the partnership the option to acquire non-permitted assignments on favorable terms. An important finding of the Tax Court was that upon formation of the partnership, Tom had no immediate plans for it other than to hold Dell stock. At no time did the partnership have a business plan and its assts consisted solely of Dell stock. Furthermore, the partnership had neither employees nor a telephone listing.

The taxpayers filed gift tax returns for 1999 making a split gift election. On this basis, Tom and his wife each claimed a gift of $601,827. This amount was based upon an independent appraisal of the limited partnership interests transferred with the appraiser applying a hefty 49.25% discount from the value of the underlying Dell shares themselves. The value reported for each of the taxpayers on the 2000 gifts of partnership interests, after the same discount, was $40,000, and likewise for the 2001 gifts.

On audit of the gift tax returns, the IRS claimed that the transfer of the Dell stock to the limited partnership was in substance an indirect gift of the stock to the other partners within the meaning of IRC § 2511. As an alternative argument, the IRS claimed that the partnership was more analogous to a trust than to an operating business, and should be valued as such. The IRS also claimed that the restrictive provisions contained in the partnership agreement should be disregarded for valuation purposes pursuant to IRC § 2703(a)(2). As another alternative argument, in the event the indirect transfer argument was not upheld, the IRS allowed a discount of only 28%, valuing each of the split gifts at $871,971. Similar adjustments were made for the 2001 and 2002 gift tax returns. Overall, the IRS increased the value of the gifts by over $660,000.

B. Tax Court Analysis

The Court noted that it was asked to compare the facts at hand to the Senda and Shepherd cases. It observed that in both of those cases the transfer of the stock and the transfer of the partnership interests occurred on the same day and were
thus integrated transactions. The facts in the instant case were held to be distinguishable. On November 2, 1999, the partnership was formed and the taxpayers transferred 70,000 Dell shares to it. Also, on that date, Janelle transferred 100 Dell shares to the partnership. In exchange, the taxpayers and Janelle received partnership interests proportionate to the number of shares transferred. It was not until November 8, 1999, 6 days later, that the taxpayers made gifts of partnership interests to Janelle both as a custodian and trustee of the trust. Since there were no simultaneous transfers as in the Shepherd and Senda cases, those cases were distinguished as being materially different on the facts.

Having differentiated the Shepherd and Senda cases, the Court moved on to an alternative argument of the IRS, namely, that the transfers were indirect gifts under the “step transaction doctrine.” Although the step transaction doctrine has been applied mostly in income tax cases, it has been applied in estate and gift tax cases.13

Referring to a prior Tax Court decision,14 the Court observed that the step transaction doctrine combines a series of integrated, interdependent steps into one step if the series of steps are focused on a particular result. It noted that although there is no universal test as to when and how the step transaction doctrine should be applied, the courts have used three alternative tests: (1) binding commitment, (2) interdependence and (3) end result. Although the IRS did not explicitly state which of these tests it was relying upon, the Court believed that it was arguing that the “interdependence” test was applicable.

Under the interdependence test the courts look to whether the separate steps each have legal significance or are so intertwined that they have significance only as part of a larger transaction. The IRS noted that a Treasury Department regulation dealing with indirect gifts is specifically in point.15 Its argument in substance was that for the taxable year 1999, the separation in time between the first two steps (formation of the partnership and funding of it) and the third step (the gift of the partnership interests) served no purpose other than to avoid making an indirect gift per the regulation.16 The Court refused to automatically conclude, however, that the hiatus of only about one week between formation and funding of the partnership and the gifts of the partnership interests resulted in the transactions being so intertwined that one step without the other would have been fruitless.

In its arguments, the IRS relied heavily on Senda,17 where funding of the partnership and gifts of partnership interests occurred on the same day. The Court found Senda distinguishable: “The passage of time may be indicative of a change in circumstances that give independent significance to a partner’s transfer of property to a partnership and the subsequent gift of an interest in that partnership to another.” Highly relevant was the Court’s observation that stock values could significantly change within one week. In fact, the Dell stock went down 1.316 percent within one week. Although this may not seem like much, based on the time elapsed, the rate of change was noted to be greater than the changes that took place in subsequent longer relative periods. The IRS even conceded that a two-month delay from funding to gifts would give independent significance to the two steps. The Court did not draw any “bright line” test as to how much time must elapse between the funding of a partnership and a gift of partnership units for there to be economic risk of a change in the value of the partnership units gifted.18 Based on the facts of the case, it concluded that the 1999 gifts of partnership units was not an indirect gift of Dell shares.
After determining that there was no indirect gift of Dell Shares, but rather a gift of limited partnership interests, the Court next concentrated on valuing the interests. In this regard, it focused on Internal Revenue Code (I.R.C.) § 2703. In pertinent part, I.R.C. § 2703(a) provides that the value of gifted property is determined without regard to any restriction on the right to sell or use such property. However, I.R.C. § 2703(b) states that I.R.C. § 2703(a) shall not apply if the restriction meets each of three requirements:

1. It is a bona fide business arrangement.

2. It is not a device to transfer the gifted property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth.

3. Its terms are comparable to similar arrangements entered into by persons in an arm’s length transaction.

The partnership contained several relevant restrictions: (1) with limited exceptions, a restriction on assigning a partnership interest without consent of all the partners, (2) an option to reacquire the interest transferred in the event of a non-permitted assignment, and (3) restrictions on payouts to reacquire a non-permitted assignment. The taxpayers argued that these restrictions served a bona fide business purpose by preventing interests in the partnership from passing to non-family members citing a number of cases in support of their argument. The IRS on the other hand argued that the transaction was not a bona fide business arrangement since “carrying on a business” requires more than holding securities and keeping records, citing a 1941 Supreme Court income tax case, Higgins v. Commissioner. Moreover, it observed that the taxpayers primary purpose in forming the partnership, to preserve their wealth and educate their children about it, were both personal and business goals.

The Court observed that I.R.C. § 2703 does not contain a definition of the phrase “bona fide business arrangement.” However, the Court noted that there could be a bona fide business arrangement without an actively managed business, citing Estate of Amlie v. Commissioner. In that case, the Court held that a fiduciary’s efforts to hedge risk and planning for liquidity needs of a decedent’s estate constitute business purposes under I.R.C. § 2703(b)(1). The Court then went on to observe that although buy-sell agreements serve a legitimate purpose in maintaining control of a business, this does not necessarily exclude the possibility that such an agreement is a tax-avoidance testamentary divide to be disregarded in valuing the property interest.

Reviewing the legislative history of I.R.C. § 2703(b)(1), the Court concluded that the restrictions in the partnership agreement in this case did not constitute a bona fide business arrangement. First of all, there was no closely held business to protect. The restrictions served principally to discourage dissipation by the children of the family wealth. This was different than the value fixing arrangements in Estate of Amlie, which involved a conservator seeking to exercise prudent management of investments for his ward and to provide for the liquidity needs of her estate.

The Court then focused on whether the second requirement for disregarding the restrictions in the partnership agreement, I.R.C. § 2703(b)(2), was met. This provision mandates that the restriction not be a divide to transfer property to members of the decedent’s family for inadequate consideration. The Court concluded that the restrictions were such a divide. The purpose of the partnership restrictions was
to discourage the taxpayer’s children from dissipating the wealth transferred to them. If a child made an impermissible transfer, the child would not realize the difference between fair market value of his partnership unit and the unit’s proportionate share of the partnership’s net asset value. Further, if a child made an impermissible transfer, the partnership could redeem the interest transferred from the transferee for less than the net asset value proportionate to the impermissible transferee’s interest in the partnership. The difference in value would inure to the benefit of the remaining children and therefore be a redistribution of wealth from a child pursuing an impermissible transfer to the remaining children, an impermissible “device.”

The third requirement that must be met for restriction to be disregarded in valuation, I.R.C. § 2703(b)(3), is that the restriction be comparable to similar arrangements entered into by persons in an arm’s-length transaction. Comparability is determined at the time the restriction is created. In this regard, there was a battle between expert witnesses. The IRS expert, a law professor, testified that in his opinion – based upon his experience and conversations with numerous practitioners – it was unlikely that a person in an arm’s-length transaction would accept the pertinent restrictions in the partnership agreement.

The taxpayers called another law professor as its expert who had practiced, written and lectured about partnership taxation and law for more than 20 years, and who had drafted numerous limited partnership agreements. His testimony was that the restrictions were comparable to provisions often found in partnership agreements among unrelated partners or were not out of the mainstream. Here, the Court seemed to fudge a little, stating that even if it found that the restrictions were similar to arrangement entered into in an arm’s length transaction satisfying I.R.C. § 2703(b)(3), it would still not disregard the restriction since they did not constitute a bona fide business arrangement under I.R.C. § 2703(b)(1), and were a prohibited device under I.R.C. § 2703(b)(2). Accordingly, it determined that it did not have to decide whether the IRS or the taxpayer was correct in applying the arm’s-length standard of I.R.C. § 2703(b)(3).25

As a final matter, the Court had to address to what extent minority and marketability discounts should be allowed, disregarding any marketability discount attributable to restrictions in the partnership agreement. Since the contending parties agreed that such discounts should be allowed, the battle then became one of the expert witnesses as to the specific discount percentages. The Court then went into lengthy discussion of the testimony and methodologies of the experts. The minority discounts claimed by the experts different for each of the three years at issue. Following are the respective discounts claimed by the parties and the amount ultimately allowed by the Court.

<table>
<thead>
<tr>
<th>Year</th>
<th>IRS Expert</th>
<th>Taxpayer Expert</th>
<th>Court</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>11.2%</td>
<td>13.4%</td>
<td>11.32%</td>
</tr>
<tr>
<td>2000</td>
<td>13.4%</td>
<td>16.3%</td>
<td>14.34</td>
</tr>
<tr>
<td>2001</td>
<td>5.0%</td>
<td>10.0%</td>
<td>4.63</td>
</tr>
</tbody>
</table>

With respect to a marketability discount, the amount claimed by the parties did not differ from year to year. The expert for the taxpayers testified that his analysis supported a marketability discount of at least 35%, settling on that amount as his testimony, whereas the IRS expert estimated that the marketability discount should be only 12.5%. The Court adopted the latter figure. Accordingly, it is clear that the opinion of the IRS expert as to both minority and marketability discounts held greater sway with the Court. In dollar terms, the
IV. BIANCE GROSS v. COMMISSIONER

As noted earlier, the Tax Court decided Biance Gross v. Commissioner\(^2\) in September of 2008, a few months after its Hollman decision. The decision in Biance Gross was rendered by the same judge.

Over a period of about three months in 1998, the taxpayer transferred in excess of $2 million of publicly traded stock to a limited partnership she had formed. Eleven days after the final transfer to the partnership, the taxpayer gifted 22.5 percent partnership interests to each of her two daughters. The taxpayer was the sole general partner. She testified that the purpose for forming the limited partnership was to have her two daughters working together in handling the family wealth. A combined minority and marketability discount of 35% was claimed on the gifts of the partnership interests. The IRS asserted that no discounts should be allowed raising essentially the same argument that it had asserted in Hollman, namely, that there was an indirect gift of the securities themselves. Again, the IRS also raised its “step transaction” argument.

Applying its Hollman rationale, the Court held that the 11 days that transpired between the funding of the partnership and the gifts of partnership units posed a real economic risk that the partnership’s value would change during this time. This was especially true since the property transferred to the partnership was heavily-traded, volatile common stocks. The IRS had stipulated to the taxpayer’s 35% discount if it lost any of the indirect gift argument and this is the discount that the Court adopted. It should be noted that the combined discount ultimately adopted by the Court in Hollman with respect to the

major gift of partnership units in 1999 came to only about 25%. It is not clear why the IRS stipulated to a higher percentage.

V. CONCLUSION

Overall, Hollman is a significant taxpayer victory although the IRS got its kicks winning the I.R.C. § 2703 argument. Siding with the taxpayers, the Court held that the gifts were of limited partnership interest rather than indirect gifts of stock. This finding resulted in the Court accepting that minority and marketability discounts of the limited partnership gifts were appropriate. Favoring the IRS, however, no discount was allowed for the restrictions in the partnership agreement since I.R.C. § 2703 was found applicable mandating that these restrictions be disregarded. Consequently, the taxpayers did not get as large of a minority and marketability discount on the limited partnership interest gifted as they claimed. One may speculate that the taxpayers did not expect to get the discounts claimed and perhaps thought that the judge would proverbially “split the baby in half.” As noted, however, the Court for the most part sided with the IRS on the amount of discounts to be allowed mostly adopting those offered by the IRS expert. Significantly, the IRS was successful in interposing I.R.C. § 2703 as being applicable to the Hollman type of situation involving publicly traded securities.

Restrictions in a limited partnership agreement are often put in for the principal purpose, or at least a major one, of increasing the amount claimed for a marketability discount. So, although some discount was allowed for marketability in Hollman, the effect of disregarding such restrictions was to reduce the amount of discount.

Hollman may perhaps present a roadmap for obtaining discounts on transfers of publicly held stock into a limited partnership followed by gifts of the partnership interests.
Clearly, there must be a hiatus between the two events. In *Hollman*, the break was about one week. The Court in a footnote, however, noted that its decision might have been different if the property being transferred were less volatile, such as preferred stock or treasury bonds. The Court did not give any guidance as to how long the hiatus must be, although as noted, the IRS seems to conclude that a two-month delay would suffice. In this regard, the IRS did not dispute that a sufficient period of time had elapsed between the formation of the limited partnership and the gifts of the partnership units in 2000 and 2001. Clearly, a taxpayer's position is stronger the longer the delay between the two events, taking into account the volatility of the securities transferred. In *Bianca Gross*, the taxpayers were, of course, on even more stable ground where the hiatus was 11 days.

**ENDNOTES**

1 Internal Revenue Code (I.R.C) § 2501(a) imposes a gift tax on the transfer of property by gift during the year, based upon the value of the gifts made during the year. The gift tax regulations (Treasury Regulation (Reg.) § 25.2511-2(a)) provide that the value of property gifted is determined by the value of the property passing from the donor and not necessarily the measure of enrichment to the donee. The gift tax applies whether the gift is direct or indirect (I.R.C.§ 2511). Also, see Reg. § 25.2511-1(h)(1) concluding that a transfer to a corporation for less than full and adequate consideration is an indirect gift to the other shareholders of the corporation. There is a gift tax exclusion per donee per year of $12,000 in 2008, which is indexed for inflation to the next lowest multiple of

$1000 (IRC § 2503(b)). Effective January 1, 2009, the annual exclusion was adjusted upward to $13,000. Also excludable are certain gift transfers for educational or medical expenses (IRC § 2503(e)). A split gift election by husband and wife double the amount excludable (IRC § 2513). Over and above the annual gift tax exclusion, there is a lifetime gift tax credit that in effect exempts $1,000,000 in value of property gifted from gift tax liability (IRC § 2505). The comparable estate tax exemption was $2,000,000 through 2008 and rose to $3,500,000 effective January 1, 2009 (IRC § 2010). Gifts over the annual exclusion made during lifetime effectively reduce the estate tax exemption. Under current law, there is no estate tax in 2010, but it reinstates in 2011 reverting to an exemption of $1,000,000. Legislation in 2009, however, will probably change all this since a new Administration and Congress have taken over. Current speculation is that the $3,500,000 exemption will be made permanent, that the estate tax will not be repealed for 2010, and that the top estate and gift tax rate will be capped at 45%.

2 The other Code provisions that the IRS has used to attack family limited partnership divide are beyond the scope of this paper. For background, however, see Edward A Renn and N. Todd Angkatavanich, *The Resurrection*, Trusts and Estates Magazine, October 2008, at 20.

3 130 T.C. 112.

4 T.C. Memo. 2008-221.

5 115 T.C. 376 (2000), *aff’d* 283 F.3d 1258 (11th Cir. 2002).

6 T.C. Memo 2004-160, *aff’d* 433 F.3d 1044 (8th Cir. 2006).

7 Supra, Note 3.

8 Technically, the partnership was formed on November 3, 1999, when a certificate of limited partnership was filed with the secretary of state.

9 Treating gifts made as being made one-half by each spouse (I.R.C. § 2513).
transferred were preferred stock or a long-term Government bond.

19 Since I.R.C. § 2703 is applicable both to estate and gift taxes, the section should have used the term “taxpayer’s family” rather than “decedent’s family.” Also, see Reg. § 25.2703-1(b)(1)(ii), which substitutes the natural objects of the transferor’s bounty for the phrase “members of the decedent’s family” apparently because I.R.C. § 2703 is interpreted as being applicable to both transfers at death and during lifetime.

20 Citations omitted.

21 312 U.S. 212 (1941).

22 T.C. Memo 2006-76.

23 Id.

24 Supra, Note 19.


26 Actually, the Court did not have to consider the applicability of I.R.C. § 2703(b)(2) either since I.R.C. § 2703(b)(1) was failed. Each of the provisions, (b)(1), (b)(2) and (b)(3) have to be met for I.R.C. § 2703 to be disregarded. For some reason the Court reviewed the applicability of I.R.C. § 2703(b)(2) although technically it did not have to. Perhaps it felt that failing two out of the three requirements for disregarding I.R.C. § 2703 buttressed its holding. In any event, the restrictions in the partnership agreement were disregarded in valuing the partnership units gifted.

27 Supra, Note 4.