2008

Estate Planning for Real Estate Investors

Farhad Aghdami

Repository Citation
http://scholarship.law.wm.edu/tax/47

Copyright c 2008 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
http://scholarship.law.wm.edu/tax
ESTATE PLANNING
FOR
REAL ESTATE INVESTORS

Presented to the
54th Annual William & Mary Tax Conference
November 13-14, 2008
Kingsmill Resort, Williamsburg, Virginia

WILLIAMS MULLEN

Farhad Aghdami
Williams Mullen
A Professional Corporation
Two James Center
1021 East Cary Street – Suite 1700
Richmond, Virginia 23219
804-783-6440
aghdami@williamsmullen.com
THIS PAGE INTENTIONALLY LEFT BLANK
INTRODUCTION.

A. **Real Estate Owners and Family Businesses.**

1. Real estate owners share all of the problems of the family business owner, in addition to the unique problems of owning real estate. However, real estate presents some opportunities that other family businesses do not share.

2. There are three basic goals of estate and gift tax planning for real estate: (1) the reduction of estate and gift taxes upon transfer; (2) the deferral of the estate and gift tax burden; and (3) the provision of the necessary liquidity to pay the taxes imposed on an illiquid asset.

3. Furthermore, while taxes cannot be ignored when planning for real estate, additional goals for the real estate owner, which can be as important as tax planning, include (1) creditor protection, (2) retention of control over the real estate by the client, (3) management succession, and (4) economic support of the family.

B. **Valuation Discounts.** The estate planning goals means that the planner for a real estate owner will be grappling with the discounts in valuation available to limited partnerships and limited liability companies, since the real estate owner will already be using these entities for business purposes. These discounts are much more easily obtained for the real estate owner, in light of the real estate assets held in the entity (as opposed to stock portfolios), but the extent of these discounts will still be subject to attack by the Service.

C. **Management Succession.** The issue of management succession is complicated for the real estate owner because the management and investment of real estate calls for knowledge and experience that many family members, other than the real estate owner, often do not possess. In addition, there are not many outside professionals with such knowledge and experience to whom the family can turn, upon the death or retirement of the real estate owner.
D. Lack of Diversification and Liquidity. Finally, clients who own real estate usually own only real estate. It is what they know and understand and they generally put any cash flow they receive from their properties back into their properties (or into new properties), to the extent they don’t need it for personal consumption purposes.

II. VALUATION BASICS.

A. Introduction.

1. The applicability and amount of valuation discounts (and premiums) are some of the most frequently litigated areas in estate and gift tax planning. The inherently subjective nature of valuation lends itself to frequent disputes between taxpayers and the Internal Revenue Service (the "Service").

2. In Estate of Auker v. Commissioner, T.C. Memo 1998-185 (1998), Judge Laro wrote:

   Disputes over valuation fill our dockets, and for good reason. We approximate that 243 sections of the Code require fair market value estimates in order to assess tax liability, and that 15 million tax returns are filed each year on which taxpayers report an event involving a valuation-related issue. It is no mystery, therefore, why valuation cases are ubiquitous. Today, valuation is a highly sophisticated process. We cannot realistically expect that litigants will, will be able to, or will want to, settle, rather than litigate, their valuation controversies if the law relating to valuation is vague or unclear. We must provide guidance on the manner in which we resolve valuation issues so as to provide a road map by which the Commissioner, taxpayers, and valuation practitioners can comprehend the rules applicable thereto and use these rules to resolve their differences. Clearly articulated rules will also assist appellate courts in their review of our decisions in the event of an appeal.

B. Fundamental Concepts of Transfer Tax Valuation.

1. Fair Market Value. Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. United States v. Cartwright, 411 U.S. 546 (1973). See also, Treas. Reg. §§ 20.2031-1(b) and 25.2512-1.

a. The willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and the individual characteristics of these hypothetical persons are not necessarily the same as the individual characteristics of the actual seller or the actual buyer. See, e.g., Estate of Bright v. U.S., 658 F.2d 999 (5th Cir. 1981); Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982).

b. The “willing buyer-willing seller” principle is an objective test rather than a subjective test. The court in Estate of Watts v. Commissioner, T.C. Memo 1985-595 (1985), explained that the test requires the transaction be analyzed from the viewpoint of a hypothetical seller whose only goal is to maximize his profit on the sale of his interest.

c. In Morrissey v. Commissioner, 243 F.3rd 1145 (9th Cir. 2001), rev’g Kuafman v. Commissioner, T.C. Memo 1999-119 (1999), the Ninth Circuit held that the Tax Court erred in not considering the price at which stock in a closely held company was sold in sales occurring 2 months after the decedent’s death. Even though the sales were among related parties, they were not closely related and had little incentive to make a gift.

d. In Mitchell v. Commissioner, 250 F.3rd 696 (9th Cir. 2001), the Ninth Circuit reversed the Tax Court’s determination of value for shares of stock owned by John Paul Mitchell in a hair care products company. The Tax Court used the company’s acquisition value (which implied control), as opposed to the company’s publicly traded value (which would imply a lack of control discount).


a. Code § 2512 discusses the valuation of gifts. It provides that "if the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift."

b. Gift transfer taxes are imposed only on what is received by the transferee, not on what was owned by the transferor. See, Tech. Adv. Mem. 9449001.


a. Code § 2031 discusses the valuation of assets held in the gross estate. It provides that "[t]he value of the gross estate of the decedent shall be determined by including to the extent provided
for in this part, the value at the time of his death of all property, 
real or personal, tangible or intangible, wherever situated."

b. Estate transfer taxes are imposed on what was held by the decedent 
at his date of death and passed to his estate, not on what is 
transferred to the beneficiaries.

5. **Sum of the Parts is Generally Less Than The Whole.** The value of a 
partial interest in a corporation or partnership rarely equals the pro rata net 
asset value of the entity in its entirety due to the legal rights and 
relationships that are established in the entity’s organizational documents 
and the application of state law to the interests being valued.

6. **Burden of Proof.** The taxpayer generally bears the burden of proof in 
valuation cases. In *Estate of Thompson v. Commissioner*, 100 AFTR 2d 
2007-5792 (2d Cir. August 23, 2007), the Second Circuit Court of Appeals 
held that the Court is not required to accept the taxpayer’s position of 
valuation when the Service has the burden of proof under Code § 7491 
and the Court rejects the Service’s valuation approach. Instead, the Court 
may fashion its own valuation methodology. In Thompson, the decedent 
owned a 20% interest in a closely held corporation. The estate valued the 
interest at $1.75 million whereas the Service valued the interest at $32 
million. The parties stipulated that the Service bore the burden of proof on 
the valuation issue under Code § 7491. The Tax Court rejected the 
Service’s valuation methodology; however, rather than simply finding for 
the estate, the Court also rejected the estate’s valuation approach. Instead, 
the Tax Court adopted its own valuation approach and determined a value 
of $13.5 million for the estate’s interest in the company. The Second 
Circuit Court of Appeals affirmed the Tax Court’s authority to adopt its 
own valuation approach and held that the Court is not required to accept 
the taxpayer’s position even after the Court rejects the approach of the 
Service. Notwithstanding section 7491, the Court reasoned that the Tax 
Court “is not bound by the formulas or opinions proffered by expert 
witnesses. It may reach a determination of value based on its own analysis 
of all the evidence in the record.”

C. **Valuation Methodology.**

1. **General Methodology.** The valuation of a business interest or real estate 
interest is typically a three-step process:

   a. First, the value of 100% of the underlying asset is determined.

   b. Second, the fractional ownership interest is applied to the value of 
   the underlying asset to determine the aliquot value of the 
   ownership interest.
c. Third, valuation discounts or premiums are applied to the ownership interest to determine its fair market value.

2. Determination of Underlying Asset Value. The first step in valuing an interest is to value the whole asset. The valuation of the whole asset depends on the nature of the asset involved.

   a. For certain assets where there is a readily available market, such as publicly-traded securities, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or bond. Treas. Reg. § 25.2512-2(b)(1).

   b. For other assets, such as stock in a closely held business or a limited partnership interest in a limited partnership, there are numerous valuation methodologies to determine the value of the underlying asset. The most frequently used valuation methodologies include the following:

      i. Capitalization of Earning Power;

      ii. Capitalization of Cash Flow;

      iii. Capitalization of Dividends;

      iv. Capitalization of Gross Revenue; and

      v. Asset or Book Value.

   c. Rev. Rul. 59-60, 1959-1 C.B. 237, is the most authoritative pronouncement by the Service as to the approach, methods, and factors to be considered in valuing shares of closely held business entities for estate and gift tax purposes. Rev Rul. 59-60 acknowledges that opinions as to value may differ widely and each case is unique, such that no generally applicable valuation formula or approach can be devised. Among the factors to be considered are the following:

      i. The nature of the business and the history of the enterprise from its inception.

      ii. The economic outlook in general and the condition and outlook of the specific industry in particular.

      iii. The book value of the stock and the financial condition of the business.
iv. The earning capacity of the company.

v. The dividend-paying capacity.

vi. Whether or not the enterprise has goodwill or other intangible value.

vii. Sales of the stock and the size of the block of stock to be valued.

viii. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.


e. Real estate interests are typically valued based on one or more of the following valuation methodologies:

i. Market approach;

ii. Income approach; and

iii. Cost approach.

3. **Determination of Aliquot Value.** The next step is simply accomplished by applying the percentage ownership interest to the value of the underlying asset. For example, if John owns 25% of a business whose underlying value is $1,000,000, the underlying value of a 25% aliquot interest is $250,000.

4. **Application of Discounts or Premiums.** The last step is to apply valuation discounts or premiums to the underlying asset. The applicability of valuation discounts is recognized by Rev. Rul. 59-60 which states that once the value of the underlying asset is determined, discounts should be applied to minority ownership interests for lack of control and lack of marketability.

a. The most frequently discussed valuation discounts include:

i. Fractional interest discounts;

ii. Minority interest discounts;
iii. Lack of marketability discounts;

iv. Capital gains or General Utilities discounts;

v. Blockage discounts;

vi. Key person discounts; and

vii. Securities laws discounts.

b. The most commonly discussed valuation premiums include:

i. Control premiums;

ii. Voting premiums; and

iii. Swing-vote premiums.

c. Each of these discounts and premiums will be discussed in greater detail, infra.

III. FRACTIONAL INTEREST DISCOUNTS.

A. Introduction.

1. A fractional interest discount is the discount applied to the ownership of an undivided interest in an asset. Because of the lack of immediate control and the problems associated with dealing with co-owners, the hypothetical willing buyer would discount the fractional interest being acquired. Each co-tenant or co-owner of the property has the right to possess and use the joint property, so long as the rights of the other co-owners are not adversely affected.

2. Unlike owners of closely held businesses that do not have the unilateral right to realize their pro rata share of the underlying value of the business's assets by causing a dissolution of the business, owners of undivided interests in real estate generally do have the power to partition. However, partitioning property is expensive and, depending upon the location of the property, partitioning may be unavailable due to the local zoning laws. Typically, the fractional interest discounts range from 10% to 25% of the pre-discount value of the underlying property.

3. In determining the value of the real estate, particular attention must be paid to the specific type of property involved. For example, in Estate of Williams, T.C. Memo 1998-59 (1998), the Court allowed a 44% discount
for an undivided one-half interest in timberland; see also, Estate of Sels, T.C. Memo 1986-501 (1986) (60% discount applied to timberland interest). By contrast, in Estate of Brocato v. Commissioner, T.C. Memo 1999-424 (1999), a 20% discount was applied to fractional interests in 9 apartment buildings in San Francisco.

B. Analyzing the Fractional Interest Discount.

1. The are a number of factors that support a fractional interest discount. See Hall, "The New Paradigm: Life After the Elimination of Valuation Discounts," Vol. 76, No. 5, Taxes, 43, May 1998. These factors include:

   a. Owners of undivided interests have unlimited liability.
   b. Undivided interests require unanimous consent for all decisions.
   c. It is difficult to use an undivided interest as collateral for a loan because creditors are reluctant to accept such an interest as collateral.
   d. Each owner has the right to use the property, subject to the rights of the other owners, although profits, if any, are shared and distributed in proportion to ownership interests.
   e. Each owner has the right to sue for partition.


   a. Usually a partition suit takes from two to five years, which would discourage an investor who contemplated suing for a partition after purchasing an interest.
   b. There is no guaranty that the sale of the property would be at its true fair market value.
   c. The sale price may be affected by the fact that it is a court sale.

3. In 54 documented undivided interest transactions, one study found the average discount to be 35%. Patchin, "Market Discounts for Undivided Minority Interests in Real Estate," 3 Real Estate Issues 14 (Fall/Winter 1988).

4. In a more recent study, the average discount in 24 transactions was 47%. See Humphrey and Humphrey, "Unsyndicated Partial Interest Discounts," The Appraisal Journal (July 1997).

C. Case Law Supporting Fractional Interest Discounts.
1. *Estate of Henry v. Commissioner*, 4 T.C. 423 (1944). The Tax Court awarded a 10% discount for a fractional 1/3 interest in undeveloped farm land. The Tax Court noted that fractional interests in highly improved downtown property, located in an urban area will, in forced sales, seldom bring an amount equal to the value of the whole.

2. *Estate of Campanari v. Commissioner*, 5 T.C. 488 (1945). The Tax Court allowed a 12.5% discount for a 1/3 interest in real estate. The Tax Court based the award on the fact that the purchaser of a minority interest subjected himself to the wishes of other owners and had no control in the management, operation, or leasing of the properties. Furthermore, it was difficult to find a buyer of a minority interest and could only do so when they could obtain all of the fractional interests making up the whole parcel.


4. *Estate of Tishman v. Commissioner*, 59-1 U.S.T.C. Par. 11875 (E.D. Va. 1959). Decedent owned ½ interest in real estate located in Richmond, Virginia. Taxpayer's expert said that a discount of 15% to 50% was merited. District Court held that a 15% discount was applicable.

5. *Estate of Whitehead v. Commissioner*, T.C. Memo 1974-53 (1974). The decedent owned a ½ interest in a ranch. The estate put on evidence as to the chilling effect of sales of a fractional interest, testimony regarding legal costs involved in partition suits, testimony from an engineer regarding surveying costs, and testimony from a real estate broker, appraiser and rancher regarding the effect on the market value of undivided interests in Texas ranch land. The Court awarded a 20% discount.

6. *Propstra v. Commissioner*, 680 F.2d. 1248 (9th Cir. 1982). The Ninth Circuit held that the value of decedent's undivided one-half community interest in real property should be discounted by 15% to account for relative unmarketability of the fractional interest. Propstra is particularly significant because the Court rejected government's "unity of ownership" theory that estate must prove that interests in property were likely to be sold separately. The Court did not assume that the decedent's interest would be sold together with the other undivided interest held by surviving spouse. Therefore, the decedent's interest was valued at less than one-half of the value of the entire parcel of real property.


9. *Pillsbury v. Commissioner*, T.C. Memo 1992-425 (1992). A majority interest in real estate was entitled to a discount since its holder would still need the consent of the minority owner to exercise all ownership rights. Thus, the Tax Court allowed the 15% discount used on the estate tax return in valuing a decedent's 77% undivided interest in real property. *Pillsbury* represents a good planning opportunity because the 77% interest in the real estate was held by a marital trust, while the other 23% interest was held in a credit-shelter trust. Cf., Priv. Ltr. Rul. 9050004.

10. *Lefrak v. Commissioner*, T.C. Memo 1993-526 (1993). The court applied a combined 20% minority discount and 10% lack of marketability discount, after holding that the transfers were transfers of fractional interests in real estate and not partnership interests because of the formalities in the case; i.e., the partnership was created after the real estate was transferred to family members, apparently to avoid local taxes on the transfer. The court also rejected the Service's position that no discount was available because the owners were family members.


12. *Barge v. Commissioner*, T.C. Memo 1997-188 (1997). The court allowed a 27.8% discount for a gift of a 25% interest in 44,972 acres of timberland. The court determined the discount by taking into account the delay a partition suit would involve, the present value of the income that would be generated from the property during the delay, and the present value of the proceeds as a result of the partition suit, and deducted from these amounts the present value of the partition costs.

13. *Estate of Williams v. Commissioner*, T.C. Memo 1998-59 (1998). The Tax Court adopted the taxpayer's contention that a 44% discount should be applied to the value of undivided one-half interests in Florida timberland that were gifted during the decedent's lifetime and that passed at the decedent's death. The Tax Court accepted the taxpayer's 44% combined discount based upon a lack of marketability discount of 20% and a lack of
control discount of 30%. The taxpayer witnesses included a real estate appraiser who appraised the underlying assets, a business appraiser who determined the applicable discounts, a real estate attorney who testified about the partition issues and costs associated with fractional interests, and a banker who testified about the unwillingness of banks to provide financing for loans secured by fractional interests.

14. *Estate of Brocato v. Commissioner*, T.C. Memo 1999-424 (1999). The Tax Court applied a 20% fractional interest discount to 9 multiple-dwelling properties in San Francisco’s Marina district. Interestingly, the Court also allowed an 11% blockage discount for 7 of the 9 properties because they competed with each other and the simultaneous sale of all 7 properties would artificially depress the market.


16. *Estate of Baird v. Commissioner*, T.C. Memo 2001-258 (2001). The Tax Court applied a 60% discount to 16 undivided fractional interests in timberland. Court recognized limited market, lack of control, under Louisiana law, over exploitation of timberland interest less than 80%, and delay in selling a partial interest.


IV. MINORITY INTEREST AND LACK OF MARKETABILITY DISCOUNTS.

A. Minority Interest Discounts.

1. A lack-of-control discount, also referred to 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, when the entity will be liquidated, and other issues that affect the financial benefits of ownership in the entity.

a. In an operating business, lack of control may also mean the interest holder will not be assured of being an officer or employee of the entity.

b. In the context of a family limited partnership or LLC, which usually involves passive investments, the lost opportunity to be an employee of the entity may not be financially significant.
2. The rights associated with control have been more particularly stated as follows:

- Elect directors and appoint management.
- Determine management compensation and perquisites.
- Set policy and change the course of business.
- Acquire or liquidate assets.
- Select people with whom to do business and award contracts.
- Make acquisitions.
- Liquidate, dissolve, sell out, or recapitalize the company.
- Sell or acquire treasury shares.
- Register the company's stock for a public offering.
- Declare and pay dividends.
- Change the articles of incorporation or bylaws.


3. For many years, the Service challenged a minority interest discount because of the theory of family attribution - i.e., minority interests held by a family should be aggregated to form a controlling block because the family is more likely to act as one unit. The Service consistently lost on this issue. See, e.g., Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982); Estate of Bright v. U.S., 658 F.2d 999 (5th Cir. 1981); Estate of Andrews v. Commissioner, 79 T.C. 938 (1982); and Estate of Lee v. Commissioner, 69 T.C. 860 (1978).

4. In Rev. Rul. 93-12, 1993-1 C.B. 202, the Service abandoned the family attribution theory. Rev. Rul. 93-12 involved a gift by a 100% shareholder of a corporation of 20% of his stock to each of his five children. The Service ruled that the family's control of the entity would not be considered in valuing the 20% interests. The Service stated:

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 a part of a controlling interest. Consequently, a minority discount would 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% or some lesser percentage of the stock immediately before the gift.

B. Lack of Marketability Discount.

1. A lack-of-marketability discount takes into account the fact that an owner of an interest in a non-publicly traded entity will have more difficulty than an owner of an interest in a publicly traded entity in finding a willing buyer and, in order to sell the interest, may incur expenses, such as legal, accounting, and syndication fees. The fact that there is not a readily accessible market to sell interests in a closely-held business substantially increases the risks of ownership due to the inability to achieve liquidity within a short period of time.

2. In Mandelbaum v. Commissioner, T.C. Memo 1995-255 (1995), Judge Laro of the Tax Court listed the following elements of value as factors that have to be taken into account in determining the appropriate discount for limited marketability:

   a. The value of the corporation's privately traded securities vis-a-vis its publicly traded securities (or, if the corporation does not have stock that is traded both publicly and privately, the value of a similar corporation's public and private stock);

   b. An analysis of the corporation's financial statements;

   c. The corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends;

   d. The nature of the corporation, its history, its position in the industry, and its economic outlook;

   e. The corporation's management;

   f. The degree of control transferred with the block of stock to be valued;

   g. Any restriction on the transferability of the corporation's stock;
h. The period of time for which an investor must hold the stock to realize a sufficient profit;

i. The corporation's redemption policy;

j. The cost of effectuating a public offering of the stock to be valued, e.g., legal, accounting, and underwriting fees.

3. The price of shares of stock or other publicly traded interests already reflects a lack-of-control discount, but does not reflect a lack-of-marketability discount because they are sold on a recognized exchange and by definition are marketable.

4. Minority interest and lack of marketability are often applied at the same time. However, a lack of marketability discount may be applied to a majority or controlling interest in an entity. See, e.g., Estate of Colley v. Commissioner, T.C. Memo 1980-107 (1980) (25% lack of marketability discount applied to 100% interest); Estate of Bennett v. Commissioner, T.C. Memo 1993-34 (1993) (15% lack of marketability discount applied to 100% interest); Estate of Luton v. Commissioner, T.C. Memo 1994-539 (1994) (20% lack of marketability discount applied to 78% interest); Gray v. Commissioner, T.C. Memo 1997-67 (1997) (15% lack of marketability discount applied to 82.49% interest). Cf., Estate of Cloutier v. Commissioner, T.C. Memo 1996-49 (1996) (no marketability discount).

5. Similarly, where a controlling block closely held stock is transferred, a lack of marketability discount may be applied simultaneously with a control premium. See, e.g., Estate of Desmond v. Commissioner, T.C. Memo 1999-76 (1999) (30% lack of marketability discount and 25% control premium applied to decedent's 81.93% interest in closely held stock).

C. Case Law Supporting Minority Interest and Marketability Discounts.

1. The Northern Trust Company v. Commissioner, 87 T.C. 349 (1986). In valuing closely-held stock held in trusts of a corporation engaged in various businesses, the Tax Court discounted the stock value by a 25% minority position discount and another 20% discount for lack of marketability. The Tax Court refused to increase the minority position discount to 35% on the basis of the taxpayers' statistical showing that, on the average, investors pay a 35% premium for stock representing control of corporations.

2. Estate of Campbell v. Commissioner, T.C. Memo 1991-615 (1991). The Decedent owned one-third of the common stock of a corporation engaged in raising crops and cattle and making fertilizer. In addition, the
corporation had substantial real estate holdings. The Tax Court applied a 35% marketability discount and a 34% minority interest discount, which combined to equal a 57% overall discount.

3. *Estate of Berg v. Commissioner*, 976 F.2d 1163 (8th Cir. 1992). A 20% minority interest and a 10% lack of marketability discount was applied to the decedent's 26.92% interest in a real estate holding company.

4. *Estate of Lauder v. Commissioner*, T.C. Memo 1994-527 (1994). In valuing the stock in a family-owned cosmetics company, the Tax Court applied a 40% discount to reflect lack of liquidity of the stock. In a prior decision, the Tax Court ignored restrictions contained in a buy-sell agreement; therefore the Tax Court determined the fair market value of the stock to be significantly more than the amount paid to the estate and reported on the estate tax return. Experts testifying on behalf of the estate suggested discounts ranging up to 90%. However, the court said such discounts are better suited to investments that pose enormous financial risks and present no market, public or private, for liquidating the investment. In contrast, the decedent had enjoyed long-term financial success and was positioned as an industry leader.

5. *Estate of McCormick v. Commissioner*, T.C. Memo 1995-371 (1995). The Tax Court applied 18% to 32% minority interest discounts and 20% to 22% lack of marketability discount to general partnership interests in two general partnerships holding real estate used for ranching and farming activities. The Court allowed such discounts, notwithstanding the fact that the general partner, under North Dakota law, could have caused a dissolution of the partnership.


8. *Estate of Brookshire v. Commissioner*, T.C. Memo 1998-365 (1998). The Tax Court applied 40% lack of marketability discount to date-of-death value of decedent's minority share of closely held family grocery business stock subject to stock-purchase agreement. The Taxpayer used two experts. The first expert considered the corporation's increased competition and decreased income in fiscal year preceding decedent's death in determining stock's value before discount. The second expert's
discount figure was supported by lack of ready market on which to sell stock, restrictive buy-sell agreements, lack of transactions involving large blocks of stock similar in size to decedent's, and fact that decedent's stock reflected minority interest.


D. Pulling It All Together - Astleford, TCM 2008-128.

1. On 8/1/96, Mrs. Astleford formed the Astleford Family Limited Partnership ("AFLP") to facilitate the continued ownership, development, and management of various real estate investments and partnership interests she owned and to facilitate gifts that she intended to make to her three adult children. On the same day, Mrs. Astleford transferred to AFLP ownership of an elder care facility. Also on the same day, Mrs. Astleford gave each of her three children a 30% limited partner interest in AFLP and retained for herself a 10% general partner interest.

2. On 12/1/97, Mrs. Astleford made additional capital contributions to AFLP by transferring to AFLP a 50% interest in Pine Bend Development Co. ("Pine Bend"), a general partnership, and her interest in 14 other real estate properties. The Pine Bend general partnership agreement did not contain any provisions relating to the transfers of interests in Pine Bend or whether such transferred interests would be general partner or assignee interests. Pine Bend owned 3,000 acres of land of which 1,187 acres consisted of agricultural farmland ("Rosemount property").

3. As a result of the additional capital contributions made on 12/1/97, Mrs. Astleford's general partner interest in AFLP increased significantly, and her children's respective limited partner interests in AFLP decreased significantly. However, also on 12/1/97, Mrs. Astleford gave to each of her three children additional limited partner interests in AFLP. These gifts had the effect of reducing Mrs. Astleford's AFLP general partner interest back down to approximately 10% and increasing the children's AFLP limited partner interests back up to approximately 30% each.
4. On audit of the 1996 and 1997 gift tax returns, the IRS increased the fair market value of a number of the properties that were transferred to AFLP and also decreased the discounts for lack of control and lack of marketability that were applied to the interests transferred.

5. There were three issues before the court: first, the value of the Rosemount property; second, whether the 50% Pine Bend interest should be valued as a general partner interest or as an assignee interest; and third, the amount of the discount for lack of control and lack of marketability that should apply to the gift of the 50% Pine Bend general partner interest and to the gift of the AFLP limited partner interests.

6. With respect to the Rosemount property, the valuation expert for Mrs. Astleford applied an absorption discount based on his opinion that a sale of the entire Rosemount property would flood the local market for farmland and would therefore reduce the per-acre price at which the Rosemount property could be sold. Believing that the Rosemount property would sell over the course of four years and would appreciate 7% each year, the expert performed a cash flow analysis using a present value discount rate of 25%.

7. The IRS's expert did not apply an absorption discount since he concluded that the entire Rosemount property likely could be sold in a single year without an absorption discount based on the fact that in 1970, the 3,000 acres of land (including the Rosemount property) had been purchased by Pine Bend in a single transaction. The IRS's expert also concluded that even if an absorption discount was appropriate, the 25% present value discount rate used by Mrs. Astleford's expert was excessive. The IRS's expert argued that the present value discount rate should track the 9.2% rate of return on equity which farmers in the area actually earned.

8. The court believed that due to the size of the Rosemount property in relation to the number of acres sold each year in the area, it was unlikely that all 1,187 acres of the Rosemount property would be sold in a single year without a price discount. However, the court also believed that the present value discount rate of 25% used by Mrs. Astleford's expert was unreasonably high because it relied on statistics relating to developers of real estate who expect greater returns given the greater risks involved in development. Since over 75% of the Rosemount property was leased to farmers, these rental payments would provide a source of future income to a prospective purchaser. The court found that given this low level of risk, a 10% rate of return would be sufficient to induce a purchase of the Rosemount property.
9. With respect to Pine Bend, the parties disputed the nature of the interest transferred by Mrs. Astleford to AFLP and therefore the appropriate amount of the discount for lack of control and lack of marketability that should apply. Because the other 50% general partner of Pine Bend did not consent to Mrs. Astleford's transfer of her general partner interest in Pine Bend to AFLP, Mrs. Astleford's expert treated the 50% Pine Bend interest transferred to AFLP as an assignee interest and applied a 5% discount. The position of Mrs. Astleford's expert was based on applicable state law that provided that a holder of an assignee interest has only a profits interest but no influence on management.

10. The court agreed with the IRS that the substance-over-form doctrine applied to treat the interest in Pine Bend that Mrs. Astleford transferred to AFLP as a general partner interest. The court based its conclusion on its finding that since Mrs. Astleford was the sole general partner of AFLP, she was essentially in the same management position relative to the 50% Pine Bend interest whether she is to be viewed as having transferred to AFLP a Pine Bend assignee interest (and thereby retaining Pine Bend management rights) or as having transferred those management rights to AFLP as a result of the transfer of a Pine Bend general partner interest (in which case she reacquired those same management rights as sole general partner of AFLP). The court also noted that the transfer documents treated Mrs. Astleford's Pine Bend transfer as a transfer of all of her rights and interests in Pine Bend, thereby suggesting that a general partner interest—not an assignee interest—was transferred.

11. Next, the court addressed the amount of the discount for lack of control and lack of marketability that should apply (1) to the limited partnership interests in AFLP given to Mrs. Astleford's three children, and (2) to the 50% Pine Bend general partnership interest she transferred to AFLP. In determining these discounts, Mrs. Astleford's expert relied on data for real estate limited partnerships ("RELPs") while the IRS's expert relied on data for real estate investment trusts ("REITs"). The court did not believe that either the RELP data or the REIT data was superior to the other. According to the court, RELPs more closely resembled AFLP, and the RELP secondary market is not so low as to render the available RELP data unreliable. However, the court also said that the large number of REIT sales transactions tended to produce more reliable data compared to the limited number of RELP sales transactions. In addition, the court stated that the differences between REITs and AFLP may be minimized given the large number of REITs from which to choose comparables. But REITs sometimes trade at prices higher than net asset value. The court recognized that this fact does not mean that a lack of control discount is nonexistent but suggests that a REIT's share price is in part affected by two factors, one positive (the liquidity premium) and one negative (lack of control). Therefore, in analyzing REIT comparables and their trading prices, the
court found it is appropriate to quantify and then to reverse out of the trading prices, any liquidity premiums that are associated with REIT comparability data. The court stated that this calculation results in a REIT discount for lack of control that can be applied to the partner interests gifted.

12. To determine the appropriate liquidity premium to apply to the REIT, the court examined the difference in average discounts in private placements of registered and unregistered stock—reasoning that the difference represents pure liquidity concerns since a public market is available to owners of registered stock but not to the owners of unregistered stock. After performing these calculations, the court applied a lack of control discount of 16.17% for the 1996 gifts and a discount of 17.47% for the 1997 gifts of AFLP by Mrs. Astleford to her children.

13. With respect to the discount for lack of marketability, the expert for Mrs. Astleford applied a discount of 15% and the IRS expert applied a discount of 21.23% for the 1996 gifts. The court, without any discussion, used the higher discount applied by the IRS expert. For the 1997 gifts, the court applied a lack of marketability discount of 22%. In valuing the 50% Pine Bend general partner interest, the IRS's expert concluded that because the Pine Bend partner interest was simply an asset of AFLP, the discounts he applied at the AFLP level obviated the need to apply an additional and separate discount at the Pine Bend level. The court disagreed and held that a 30% combined discount for lack of control and lack of marketability was appropriate. In a footnote, the court mentioned that the Tax Court has rejected multiple discounts in the context of tiered entities where the lower level interest constituted a significant portion of the parent entity's assets. However, in this case, the 50% Pine Bend interest constituted less than 16% of the net asset value of AFLP and was only one of 15 real estate investments that were held by AFLP.
V. CAPITAL GAIN DISCOUNT

A. Introduction.

1. A prospective buyer of shares of stock in a C corporation whose fair market value is based on the value of its underlying assets rather than its going concern value, such as a C corporation that owns passive real estate or marketable securities, will take into consideration in determining what he or she is willing to pay for the shares the potential capital gains that the C corporation will recognize when it disposes of assets that have unrealized appreciation (built-in gains).

2. Prior to the Tax Reform Act of 1986, it was possible to liquidate the assets of a C corporation without recognizing gain at the corporate level through a 12-month tax-free liquidation, under the so-called General Utilities doctrine.

3. The Tax Reform Act of 1986 repealed the General Utilities doctrine, so that it is no longer possible to exit a C corporation without having the built-in gains subject to tax at the corporate level.

   a. However, if the C corporation makes an S election and disposes of the appreciated assets after the election has been in effect for ten years, the built-in gain tax no longer applies.

   b. In the case of a S corporation that holds passive investments, the S election may be terminated after three years unless it distributes all its C corporation earnings and profits before the end of its third S corporation year.

B. Case Law before Davis.

1. In the cases decided before 1998, taxpayers were unsuccessful in having the value of an interest in a C corporation reduced because of the potential capital gains tax on unrealized appreciation.

2. In most cases, the rationale of the Court was that the liquidation of the corporation or the disposition of the appreciated assets was speculative unless there was evidence that the corporation was going to be liquidated or the assets were going to be sold in the near future. In addition, if the corporation decided to dispose of its assets, it could do so in a tax-free liquidation.

3. After the repeal of the General Utilities doctrine in 1986, Courts continued to deny discounts for potential capital gains tax because the liquidation of the corporation was not likely to occur in the near future or an S election could be made.
C. Davis and Eisenberg Cases.

1. In Davis v. Commissioner, 110 T.C. 35 (1998), the Tax Court, held that, even though no liquidation of the corporation or the sale of its assets was planned or contemplated on the date that shares of stock in a closely-held corporation were gifted, a hypothetical willing seller and a hypothetical willing buyer would have taken into account the corporation's potential built-in gains tax.
   a. Over 87% of the corporation’s assets consisted of highly appreciated Winn Dixie stock.
   b. Even the Service's expert agreed that a 15% discount was appropriate to take into account the built-in capital gains tax.

2. On August 18, 1998, the U.S. Court of Appeals for the Second Circuit remanded a case that had been decided by the Tax Court before the Davis decision holding that no discount was appropriate for the built-in capital gains. Eisenberg v. Commissioner, 155 F.3d 50 (2nd Cir. 1999), rev'g T.C. Memo. 1997-483 (1997).

3. Finally, in AOD 1999-001, 1999-4 I.R.B, issued February 1, 1999, the Service acquiesced in the Eisenberg case and stated:

   We acquiesce in this opinion to the extent that it holds there is no legal prohibition against such a discount. The applicability of such a discount, as well as its amount, will hereafter be treated as factual matters to be determined by competent testimony based upon the circumstance of each case and generally applicable valuation principles.

D. Beyond Eisenberg and Davis.

1. In Simplot v. Commissioner, 249 F3d. 1191 (9th Cir. 2001), rev’g 112 T.C. 130 (1999), a case involving the appropriate premium to be added to the voting shares of common stock when the corporate capital structure included voting and nonvoting common stock, the experts for both the taxpayer and the government reduced the value of publicly traded stock the corporation owned in another company by the capital gains tax on the unrealized appreciation and the estimated expenses the corporation would have incurred in disposing of the publicly traded stock.

2. Estate of Jameson v. Commissioner, 267 F.3rd 366 (5th Cir. 2001), vac’g and rem’g T.C. Memo 1999-43 (1999), was the first case to require the use of a hypothetical (not specific) buyer for valuation of the built-in capital gains discount. The Executor filed suit in Tax Court to dispute the Commissioner’s assertion that no built-in capital gains discount was
necessary in valuing the stock left by decedent to his son. The stock was in a company named Johnco, which had its principal assets in 5,000+ acres of timber property in Louisiana. The appraiser of the estate argued that a discount of 20-30% was necessary to discount the built-in capital gains tax in case of liquidation. The Commissioner argued, and the Tax Court agreed, that the timber property would not be liquidated if sold because it was far more valuable while in operation. On appeal, the court held that the Tax Court should have used hypothetical, not actual, buyers and sellers to determine the fair market value of the property. Using this basis, the court concluded that a hypothetical purchaser “would have to take into account the consequences of the unavoidable, substantial built-in tax liability on the property.” \textit{Id.} at 372. The court did not pinpoint which percentage would be appropriate for this discount, but remanded the case to the Tax Court for further review.

3. \textit{Estate of Dunn v. Commn'\text{r}}, 301 F.3d 339 (2002), was the first case to require the value of the corporation to be reduced by 100% of the built-in capital gain taxes, regardless of the corporation’s potential liquidation. The Executor filed suit in the Tax Court to dispute Commissioner’s valuation of decedent’s stock in Dunn Equipment, Inc. without a discount for its built-in tax liability. The appraiser of the estate argued for a discount of 34% as the actual rate that Dunn Equipment would have incurred on sale to a hypothetical buyer. The Commissioner argued for no discount because liquidation not imminent. The Tax Court applied a 5% discount. On appeal, the estate argued that “like advertising and transportation costs, commissions, and other unavoidable expenses of disposition of these assets accepted by the Tax Court, the assets’ gross value must be reduced by their built-in gains tax liability to reach their fair market value.” \textit{Id.} at 352. The court agreed, lambasting the Tax Court for its continued reliance on the probability of liquidation in determining the appropriate built-in capital gains discount. The court unequivocally stated: “The process of determining the value of the assets or this facet of the asset-based valuation methodology must start with the basic assumption that all assets will be sold . . . when the starting point is the assumption of sale, the ‘likelihood’ is 100%! . . . Bottom Line: The likelihood of liquidation has no place in either of the two disparate approaches to valuing this particular operating company.” \textit{Id.} at 353-54. In conclusion, the court affirmed the estate’s 34% discount because a hypothetical buyer would demand such a reduction for the built-in gains tax liability of Dunn Equipment. As the Eleventh Circuit said years later, “An era of valuation certainty had begun.” \textit{Estate of Jelke v. Commn'\text{r}}, 507 F.3d 1317, 1329 (2007).)

4. \textit{Estate of Jelke v. Commn'\text{r}}, 507 F.3d 1317 (2007) was the first case to affirm \textit{Dunn} by requiring the value of the corporation to be reduced by 100% of the built-in capital gain taxes, regardless of the corporation’s
potential liquidity. The estate filed a tax return that reduced the value of
his Commercial Chemical Company (CCC) shares by 100% of the built-in
capital gains tax liability, or dollar-for-dollar. The Commissioner
determined that the estate owed over $2 million for undervaluation. The
Tax Court agreed that the discount was available, but disagreed that it
should be dollar-for-dollar. Rather, it held that the discount should reflect
the fact that CCC would probably not be liquidated for sixteen years. The
Eleventh Circuit Court of Appeals reversed, holding that “the rationale of
the Fifth Circuit in the Estate of Dunn eliminates the crystal ball and the
coin flip and provides certainty and finality to valuation as best it can,
already a vague and shadowy undertaking. It is a welcome road map for
those in the judiciary, not formally trained in the art of valuation... this
100% approach settles the issue as a matter of law, and provides certainty
that is typically missing in the valuation arena.” Id. at 1332-33. Although
the court did not provide an exact amount for the discount percentage to
be followed in the future, it states in a footnote: “Given the maximum
capital gains tax rate at this writing of 15 for future cases, one can only
speculate that the maximum capital gains tax rate will not again approach
the 34 range seen in previous cases.” Id. at n.45.

E. Code § 754 Discounts?: The Partnership Analogy to the Capital Gain Discount.

1. Under general principles of partnership law, a partner’s outside basis is
stepped up in connection with a taxable sale or at death, but the partner’s
inside basis in partnership assets is not stepped up unless the partnership
(and not the partner) makes an election, under Code § 754, to step the
inside basis of the assets under Code § 734 and 743.

2. In Jones v. Commissioner, 116 T.C. 11 (2001), the Tax Court considered
and rejected the taxpayer’s argument that a discount should be applied to
the partnership interests being valued. The Tax Court did not allow a
Code § 754 discount because the court found that, a seller/purchaser of the
interest (a 83.09% limited partnership interest) would, in all likelihood be
able to prevail upon the general partner to make the election.

VI. OTHER DISCOUNTS – BLOCKAGE, SECURITIES LAWS, AND KEY PERSON.

A. Blockage or Market Absorption Discount.

1. When valuing publicly traded securities, reference is typically made to the
market price at the time of valuation. When a large block of property is
being valued, the proper approach is to value the block as a whole as if all
the items were offered for sale at the moment of transfer, and not on an
item-by-item basis. The law of supply and demand supports the
application of a blockage discount where the sale of an exceptionally large
block of one type of property may generate less proceeds than if the seller
were to sell each piece of that block separately at the market price. The market may only handle so many pieces of one type of property in a limited time, and, when the tendered number of a single type of property is greater than the number that the market can absorb, the market is unable to handle the exceptionally large block at that time. Thus, a seller desiring to sell such a large block at that time may be forced to sell the block at a price per piece that is less than the quoted price for each piece.

2. Blockage discounts are specifically addressed under Treas. Reg. §§ 20.2031-2(e) and 25.2512-2(e); however, the regulations suggest a very limited role for blockage discounts by stating that they are only available in "certain exceptional cases." The case law is substantially more liberal and accepts blockage discounts where the taxpayer adequately demonstrates the appropriateness of the discount. See, e.g., Helvering v. Maytag, 125 F.2d 55 (8th Cir. 1942), cert. denied, 316 U.S. 689 (1942); Bull v. Smith, 119 F.2d 490 (2d Cir. 1941); Richardson v. Commissioner, 151 F.2d 102 (2d Cir. 1945), cert. denied, 326 U.S. 796 (1946); Havemeyer v. U.S., 59 F. Supp. 537 (Ct. Cl. 1945), cert. denied, 326 U.S. 759 (1945); Standish v. Commissioner, 8 T.C. 1204 (1947), acq., 1947-2 C.B. 4; Rushton v. Commissioner, 498 F.2d 88 (5th Cir. 1974); Estate of Smith v. Commissioner, 57 T.C. 650 (1972), aff'd, 510 F.2d 479 (2d Cir. 1975), cert. denied, 423 U.S. 827 (1975); Robinson v. Commissioner, 50 T.C.M. 89 (1985); Gillespie v. U.S., 23 F.3d 36 (2d Cir. 1994).


4. A "blockage" discount is typically used to describe the discount applied to the sale of a large block of stock, whereas a "market absorption discount" is typically used to refer to the sale of other types of property. For example, market absorption discounts have been applied to artistic and literary items including the following:

   a. Calder v. Commissioner, 85 T.C. 713 (1985) (market absorption discount applied to gifts of a large number of works of art created by one artist);

   b. Estate of Smith v. Commissioner, 57 T.C.650 (1972) (market absorption discount applied to 425 works of art created by and kept in sculptor's collection), aff'd on other grounds 510 F.2d 479 (2d Cir. 1975);

   c. Estate of O'Keeffe v. Commissioner, T.C. Memo. 1992-210 (market absorption discount applied to approximately 400 works or groups of works of art);
d. **Rimmer v. Commissioner**, T.C. Memo. 1995-215 (market absorption discount applied to charitable contribution of collection of sheet music containing approximately 85,000 pieces);

e. **Jarre v. Commissioner**, 64 T.C. 183 (1975) (market absorption discount applied to charitable contribution of large collection of original music manuscripts and other related material);

f. **Skripak v. Commissioner**, 84 T.C. 285 (1985) (market absorption discount applied to charitable contribution of large collection of books);

g. **Epping v. Commissioner**, T.C. Memo. 1992-279 (market absorption discount applied to charitable gift of mainly animal mounts); and


5. Market absorption discounts have also been applied to real estate, including the following cases:

a. **Estate of Sturgis v. Commissioner**, T.C. Memo. 1987-415 (20% market absorption discount applied to 11,298.86 acres of undeveloped land);

b. **Carr v. Commissioner**, T.C. Memo. 1985-19 (30% market absorption discount applied to 175 developed lots; no discount applied to 437.5 undeveloped lots);

c. **Estate of Folks v. Commissioner**, T.C. Memo. 1982-43 (20% market absorption discount applied to five leased lumberyards with the same tenant and in the same geographical area);

d. **Estate of Grootemaat v. Commissioner**, T.C. Memo. 1979-49 (15% market absorption discount applied to undeveloped lots totaling 302 acres);

e. **Estate of Auker v. Commissioner**, T.C. Memo 1998-185 (1998) (6.189% market absorption discount applied to apartment complexes); and

f. **Estate of Brocato v. Commissioner**, T.C. Memo 1999-424 (1999) (In addition to 20% fractional interest discount, 11% blockage
discount awarded for 7 of 9 multiple tenant dwellings in San Francisco's Marina District).

B. Securities Laws Discount.

1. The Securities Act of 1933 prohibits the sale of any securities which are not registered, unless a specific exemption applies. In general, any security which has not been registered is referred to as a restricted security. Pursuant to Securities and Exchange Commission's (SEC) Rule 144(a)(3), securities are considered restricted if they are acquired from: (1) an issuer or an affiliate of the issuer in a non-public transaction; (2) an issuer in an offering exempted from registration pursuant to Rule 505 (certain offerings not exceeding $5 million), Rule 506 (certain offerings permitted without regard to dollar amount offered), Rule 701 (certain issuances in connection with employee compensation plans), or Rule 1001 (certain offerings of up to $5 million that are exempt under §25102(n) of the California Corporations Code); or (3) an affiliate or a non-affiliate in a transaction qualifying for exemption from registration under Rule 144A (certain sales of restricted securities to qualified institutional buyers).

2. Rev. Rul. 77-287, 1977-2 C.B. 319. The Service addressed the proper valuation of securities restricted from immediate resale under the federal securities laws. In determining the appropriate amount of discount, the difference between the fair market value of registered, actively traded common stock and stock of the same class which cannot be publicly traded should be measured. The Service concluded that, while no automatic formula can be used to determine discounts for restricted securities, such discounts are generally: (1) related to the size of the issuing corporation measured by its sales (companies with the lowest dollar amount of sales get the highest discounts); (2) the size and pattern of its earnings; (3) a function of the trading market for the equivalent actively traded stock (discounts on the "over the counter" (OTC) market were the greatest followed by the American Stock Exchange (ASE), while the New York Stock Exchange (NYSE) discounts were the least); and (4) a function of the resale agreement provisions affecting the restricted security (e.g., an option to require registration at the seller's expense, "piggyback" registration rights). The Ruling also clearly states that the costs of registering the shares, but not the costs of underwriting, may be included in valuing the discount.

3. The Tax Court has largely adopted the approach found in Rev. Rul. 77-287. See, e.g., Estate of Little v. Commissioner, T.C. Memo 1982-26 (1982) (Combined 60% discount was allowed by the court for the total of the securities law restrictions, restrictions placed on the stock by virtue of a voting proxy and escrow agreement, and blockage discounts); Estate of Brownell v. Commissioner, T.C. Memo 1982-632 (1982) (33% discount
applied to shares that could only be sold through a private placement); *Estate of Stratton v. Commissioner*, T.C. Memo 1982-744 (1982) (a large block of was permitted a 25% discount to reflect the price it would bring in a private placement); *Estate of Sullivan v. Commissioner* T.C. Memo 1983-185, (1983) (14.6% of the outstanding stock of Eckerd Drugs was discounted by 15% to reflect the price it would bring in a private placement); *Estate of Gilford v. Commissioner*, 88 T.C. 38 (1987) (decedent's block was sold in a private placement six months after the decedent's death as part of a merger; nevertheless, the court allowed a 33% discount for the Rule 144 restriction which burdened the stock);

4. *Estate of McClatchy v. Commissioner*, 147 F.3d 1089 (1998), rev 'g 106 T.C. 206 (1996). The decedent owned unregistered stock that was subject to restrictions under Rule 144. Although the decedent was an affiliate of the corporation for securities law purposes, his estate and his personal representatives were not collectively an affiliate of the corporation, causing the stock to be released from the Rule 144 restrictions at his death. Nevertheless, the estate discounted the value of the stock on the estate tax return, arguing that the reportable value of the stock was its value in the decedent's hands at his death.

   a. The Tax Court, however, concluded that the stock must be valued at the moment of death, taking into account any change in valuation that occurred as a result of death. Since the decedent's death removed the restrictions, the court found that the stock must be valued without consideration of them.

   b. On appeal, the Ninth Circuit reversed the Tax Court, finding that the value of the stock in the hands of the decedent was controlling. The Ninth Circuit held that the estate tax is imposed on the value of property passing at death; therefore, the removal of the restrictions was caused not by the decedent's death, but by the receipt of the property by his personal representative, who was not an affiliate for purposes of Rule 144. The court also concluded that the value of the stock should not depend upon the identity of the recipient, in this case the decedent's estate.

C. **Key Person Discount.**

1. Where a corporation is substantially dependent upon the services of one person, and where that person would no longer be able to perform services for the corporation by reason of death or incapacity, an investor would expect some form of discount below fair market value when purchasing stock in the corporation to compensate for the loss of that key employee.

2. Rev. Rul. 59-60 explains that in valuing the stock of a closely held
business, the loss of a key person may have a depressing effect upon the value of such business. The ruling also states that the loss of the key person and the absence of management succession potentialities should be taken into consideration in analyzing the future expectancy of the business. However, the ruling further explains that consideration must be given to whether the business is of a type that will not be impaired by the absence of the individual and whether the loss to the business is either adequately covered by life insurance or mitigated by the ability to employ competent management for the same consideration that was paid to the decedent.

3. The Tax Court has rejected the Service's assertion that the loss of a key person can be offset by life insurance proceeds and other factors. In Estate of Rodriguez v. Commissioner, T.C. Memo 1989-13 (1989), the court rejected the Service's assertion that no adjustment was necessary merely because the business held a life insurance policy on the key person's life. In the court's opinion, this understated the importance of the key person.

4. In Estate of Feldmar v. Commissioner, T.C. Memo. 1988-429 (1988), the Court rejected the Service's assertion that no key person discount should be applied because the loss of the decedent's services were more than compensated by insurance, on the basis that insurance proceeds are more in the nature of a non-operating asset and thus would not enter into a going concern valuation. The Feldmar court held that an investor would expect a 35% discount for the loss of a key employee "because (the business) suffered a serious loss when (the) decedent took to his grave his considerable expertise." The Court reduced the discount to 25% to account for the possibility of the business finding a new leader to replace the decedent.


VII. SWING-VOTE PREMIUM, VOTING PREMIUM, AND CONTROL PREMIUM

A. Swing Vote Premium

1. A swing vote premium may be applied in cases where, as a result of the ownership percentages of other shareholders, the holder of the subject shares is able to combine his voting power with another shareholder and effectively control the corporation. A swing vote premium has not been addressed in the context of limited partnerships, but it is likely that the
analysis applicable to voting shares of a corporation will be equally applicable to general partner interests in limited partnerships.

2. One of the first cases to address the issue of a swing vote premium in the context of a corporation was Estate of Winkler v. Commissioner, T.C. Memo 1989-231 (1989). In Winkler, 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. The 10% block of stock was subject to a 10% premium instead of a minority interest discount as argued by the estate.

3. In Tech. Adv. Mem. 9436005, the Service ruled that a swing vote premium should be applied to gifts of 30% interests in a corporation to the children of the donor. The Service reasoned that the block of stock enabled the transferee to join with another related owner of an interest in the entity to form a majority interest.

4. The application of the swing vote concept has been broadly criticized for two reasons.
   a. First, pursuant to the willing buyer-willing seller concept, it is difficult to conceive that an arms-length buyer without any prearranged agreement, would attach additional value to a minority interest.
   b. Secondly, the use of this concept totally ignores the concept of the transfer tax that valuation applies to what is being transferred, not the speculative value of what is created following the event of transfer.

B. Voting Premium – Estate of Simplot, 112 T.C. 13 (1999), reversed, 249 F3d. 1191, 2001 (9th Cir.)

1. The corporation had two classes of stock: Class A voting (of which there were 76,445 shares outstanding) and Class B nonvoting (of which there were 141,288.584 shares outstanding). The decedent and two of his siblings each owned 18 shares (or 23.55%) of voting stock each, and a fourth sibling owned the remaining 22.445 shares. If a Class A voting shareholder wanted to sell his Class A voting stock, the stock first had to be offered to the corporation for a period of 180 days, and then (if the corporation declined to exercise its right to purchase the stock) to the other Class A voting shareholders for an additional 180 days.

2. The Tax Court valued a decedent's voting stock of a closely held corporation by adding, to each voting share's pro rata share of the equity value of the corporation, a voting rights premium expressed as 3% of the
corporation's total equity value (including both voting and nonvoting stock). In so holding, the court rejected the estate's argument that the premium, if any, to be accorded to the voting rights should be expressed in terms of a percentage of the nonvoting stock only. The Tax Court said that the Class A shares, on a per-share basis, were far more valuable than the Class B shares because of the former's inherent potential for influence and control of the corporation. Through ownership of the decedent's voting shares, a hypothetical buyer would gain access to the "inner circle" of the corporation, and, by having a seat at the Class A shareholders' table, over time, the hypothetical buyer potentially could position itself to play a role in the corporation. The court agreed with IRS's expert that, on the valuation date, a hypothetical buyer would consider the likelihood that one day the decedent's block of voting shares potentially could become the largest block of voting shares because the record revealed that the decedent's siblings intended, upon their deaths, to pass their Class A shares to their children, and thereafter no shareholder (other than the hypothetical buyer) would own 18 shares of voting stock. Moreover, it was foreseeable on the valuation date that, after the deaths of the decedent's siblings, younger generation family members would be more likely to sell their voting shares to outsiders than their parents would. At that time, the hypothetical buyer would benefit from the right of first refusal restriction on the voting stock.

3. The Tax Court also noted that the corporation had an extreme ratio of nonvoting to voting shares: 1,848.24 to one. The court agreed with IRS's expert that the disparate ratio of nonvoting to voting stock in this case was particularly important because it dramatically increased, on a per-share basis, the value of the Class A shares.

4. The Tax Court stressed that it was not valuing a premium for controlling voting power, but rather a premium for voting rights. The court said that the premium for controlling voting power would be substantially greater than the premium it determined for voting rights.

5. The Ninth Circuit reversed.

a. The Ninth Circuit believed that the Tax Court departed from the hypothetical willing buyer standard because the Tax Court believed that "the hypothetical sale should not be constructed in a vacuum isolated from the actual facts that affect value." The Ninth Circuit believed the Tax Court relied on "imagined facts" and said, "In violation of the law the Tax Court constructed particular possible purchasers."

b. The Ninth Circuit also determined that the Tax Court's premium calculation was incorrect. The Tax Court calculated the premium
that all the Class A shares as a block would command and then divided this premium by the number of Class A shares. The Ninth Circuit said, "... the Tax Court valued an asset not before it -- all the Class A stock representing complete control. There was no basis for supposing that whatever value attached to complete control a proportionate share of that value attached to each fraction of the whole...."

c. The final error was that even a controlling block of stock is should not be valued at a premium for estate tax purposes, unless the IRS can show that a purchaser would be able to use the control in a manner that assured an increased economic advantage worth paying a premium for. The Ninth Circuit noted, "No seat at the table was assured by this minority interest; it could not elect a director. The Commissioner points out that Class A shareholders had formed businesses that did business with Simplot. If these businesses enjoyed special advantages, the Class A shareholders would have been liable for breach of their fiduciary duty to the Class B shareholders."

d. The Ninth Circuit said that much of the IRS' argument was devoted to speculation as to what might happen after the valuation date, noting, "Speculation is easy but not a proper way to value the transfer at the time of the decedent's death. [citation omitted]. In Richard Simplot's hands at the time of transfer his stock was worth what a willing buyer would have paid for the economic benefits presently attached to the stock. By this standard, a minority holding Class A share was worth no more than a Class B share."

C. Control Premium.

1. If shares of a block of stock constitute actual voting control of the corporation, those shares may possess an additional measure of value because the shares in the block control the corporation. "Control means that, because of the interest owned, the shareholder can unilaterally direct corporate action, select management, decide the amount of distribution, rearrange the corporation's capital structure, and decide whether to liquidate, merge, or sell assets." See, Estate of Newhouse v. Commissioner, 94 T.C. 193, 251-52 (1990), nonacq., 1991-1 C.B. 1. As such, determining the fair market value of a controlling interest may require adjustment to reflect a "control premium."

2. The gift and estate tax regulations maintain, in both the publicly traded and closely held contexts, that the degree of control represented by a block of stock is relevant to valuation. Treas. Regs. §§ 20.2031-2(e) and (f) and 25.2512-2(e) and (f). Rev. Rul. 59-60 states that states that "[t]he 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's 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."

3. Case Law Involving the Application of a Control Premium to More Than a 50% Interest.

a. *Estate of Salsbury v. Commissioner*, T.C. Memo 1975-333 (1975). The Tax Court applied a 38.1% premium for control in valuing a 52% voting interest in a family corporation engaged in manufacturing animal health products. This percentage was based on an expert witness's research of premiums paid in mergers and acquisitions in the valuation year.


c. *Estate of Feldmar v. Commissioner*, T.C. Memo 1988-429 (1988). The Court concluded that investors would be willing to pay a 15% premium for a controlling block of shares. However, the court also correctly concluded that the control premium should be offset by a discount for loss of a key person.

d. *Oman v. Commissioner*, T.C. Memo 1987-71 (1987). The Court determined that a control premium of 20% should be applied when valuing a 75% interest in a closely held corporation because a purchaser would have been able to liquidate the company and control the management and policies of the company.

e. *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978). The court determined that a control premium was not appropriate in valuing a block of 80% of the outstanding stock that was held by the decedent and her husband as community property. The court based its conclusion on its opinion that the State of Washington, where the decedent was domiciled, followed the "item theory" of community property, which provides that each spouse has an undivided interest in each community asset as opposed to an undivided interest in the community property as a whole, which is the case in an aggregate theory state.

4. Case Law Involving a 50% Interest.
a. *Wheeler v. United States*, (1995, DC TX) 77 AFTR 2d 96-1405, *rev'd on other issue* (1997, CA5) 80 AFTR 2d 97-5075, 97-2 USTC. A federal district court allowed a 10% minority discount for a decedent's shares of voting stock in a closely held corporation. The Each of the sons had owned 25% of the voting stock and 50% of the non-voting stock. Although a minority interest is generally thought of as being less than 50%, the minority discount for tax purposes is given based on lack of control. A shareholder with 50% of the stock can block action by other shareholders but does not have a sufficient interest to control corporate affairs. Where indications of value are based upon control or complete ownership, a discount must be applied to provide indications of value for a minority or *less-than-controlling* interest.

b. *Obermer v. United States*, 238 F. Supp. 29 (HI 1964). The value of a husband's 50% share interest in a corporation owned 50-50 by him and his wife was discounted 33 1/3 % partly because his 50% interest couldn't force liquidation of the corporation.

5. Case Law Involving Less Than a 50% Interest.

a. *Estate of Schneider-Paas v. Commissioner*, T.C. Memo 1969-21 (1969). The Tax Court applied a control premium where a 39% ownership in a German close corporation, under the charter and bylaws, assured the owner of at least the vice-chairmanship.

b. In *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 251-52 (1990), *nonacq.*, 1991-1 C.B. 1., the decedent's ownership interest was less than 50%. The Tax Court held that a control premium was not supportable even though the decedent owned the largest block of stock (44.44%). The decedent did not have effective control because he could not accomplish any of the following: unilaterally direct corporate action; select management; decide the amount of distributions; rearrange the corporation's capital structure; or decide whether to liquidate, merge, or sell assets.

c. *Estate of Wright v. Commissioner*, T.C. Memo 1997-53 (1997). The Tax Court rejected the Service's argument that a control premium should be where the decedent owned 23.8% of the outstanding stock of a closely held corporation, with 9.4% being the most shares owned by any other shareholder. The Service argued that a control premium was justified, because the decedent's block of stock could control one member of the board of directors and thereby "substantially influence" corporate action and cause the sale of the corporation's assets. But the Tax Court, relying on
its decision in Newhouse, said that more than "substantial influence" is required before a control premium may be applied. The Court also noted that IRS, in treating the decedent's holding as part of a hypothetical 51% controlling interest, had effectively ignored the requirement in the corporation's articles of incorporation of a 66-2/3 % super majority for decisions regarding the merger, consolidation, dissolution, or sale of all or substantially all of the corporation's assets.

VIII. VALUATION DISCOUNT PLANNING OPPORTUNITIES AND PITFALLS.


1. Although the estate tax and the gift tax are generally construed in pari materia, there are some material differences in the administration of the two taxes.

a. The estate tax is an excise tax on the aggregation of all of the assets in the decedent's estate.

b. By contrast, the gift tax is imposed on the property passing from the donor to each donee; it is the value of that property passing from the donor to the donee that is the basis for measuring the tax. Thus, where a donor makes simultaneous gifts of property to multiple donees, the gift tax is imposed on the value of each separate gift.

c. Accordingly, the value of property that is the subject of multiple simultaneous gifts may be different from the value of that same property if that property were included in the donor's gross estate at his death.

d. For example, X owns 100% of the stock of ABC Corp. X wants to transfer 25% of the stock to each of his four children. If X gifts the stock to each of his children, each 25% block of stock should be entitled to a minority interest discount and possibly a lack of marketability discount. If X bequeaths 25% of his stock to each of his four children, X is treated as owning 100% of the stock and no valuation discounts are available.

e. There is ample case law supporting this principle. See, e.g., Rushton v. Commissioner, 498 F.2d 88, 93 (5th Cir. 1974), affg. 60 T.C. 272 (1973); Calder v. Commissioner, 85 T.C. 713, 720-721 (1985); Standish v. Commissioner, 8 T.C. 1204, 1209 (1947); Clause v. Commissioner, 5 T.C. 647, 649-650 (1945), affd. per curiam 154 F.2d 655 (3d Cir. 1946); Avery v. Commissioner, 3

2. The Sliver Gift Cases – Murphy and Frank.

a. Estate of Murphy v. Commissioner, T.C. Memo 1990-472 (1990). For many years, the decedent owned and controlled (through a general power of appointment) 51.41% of the stock of a closely held corporation. Eighteen days before her death, the decedent transferred shares representing 0.88% of the stock to each of her children. After her death, the remaining 49.65% of the stock was distributed to her children. The Tax Court denied a minority discount because the decedent had transferred shares shortly before her death in order to reduce her interest below 50%. The Tax Court found that the decedent had a controlling interest in the corporation and that the pre-death transfer lacked substance because there was a clear understanding between the decedent and her children to maintain family control of the business. The Tax Court observed:

The rationale for allowing a minority discount does not apply because decedent and her children continuously exercised control powers. For example, decedent remained as chairman of the board after the transfer of stock to her children. 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.

b. Estate of Frank v. Commissioner, T.C. Memo 1995-132 (1995). Anthony Frank owned 50.3% of the stock of Magton, Inc. a closely held corporation in the hotel business in New Jersey. His wife, Margaret owned 13.57% of the stock. Two days before Anthony's death, his son, Anthony, Jr., acting pursuant to a power of attorney, gifted 18.16% of the stock owned by Anthony to Margaret. Margaret died 15 days after Anthony. At the time of their respective deaths, Anthony owned 32.14% of Magton and Margaret owned 31.73% of the stock of Magton.

i. The Tax Court held that the transfers of stock were valid transfers and each of decedents died possessed of only a minority interest in Magton. The Court then applied successive 30% lack of marketability and 20% minority interest discounts, thereby discounting the collective 64.87% block of stock owned by Anthony and Margaret by 45%.
ii. In a twist on the adage "Pigs get fat and hogs get slaughtered", the Court observed that "[i]f tax avoidance was the sole motive, a substantially smaller number of shares could have been transferred. We find it unnecessary to decide this dispute over the motive for the transfer. . . As a general rule, we will respect the form of a transaction. We will not apply substance over form principles unless the circumstances so warrant." The "pigs" in Murphy did not fare nearly as well as the "hogs" in Frank.

iii. Query whether Rev. Rul. 93-12, which was promulgated in the interim made a difference? In that Ruling, the donor owned all of the single outstanding class of stock in a corporation and transferred all of the shares by making simultaneous gifts of 20% of the shares to each of the donor's five children. The ruling holds that the shares of other family members will not be aggregated with the transferred shares to determine whether the transferred shares should be valued as part of a controlling interest.

c. See also, Estate of Cidulka v. Commissioner, T.C. Memo 1996-149 (1996).


a. Tech. Adv. Mem. 9449001. The donor owned 100% of the X Corporation stock. The corporation had only one class of common stock outstanding. The donor subsequently transferred all of the stock in the corporation by making equal gifts of the stock to each of his 11 children. After the transfer, the corporation stock was owned by 11 individual shareholders, each of whom owned less than 10% of the outstanding stock. The Service concluded:

Whether the donor owns 100% of the corporation or owns a lesser controlling interest prior to the transfer, and whether the donees are family members or various third parties, are not determining factors in valuing a block of stock transferred to a donee or in deciding whether a separate gift is subject to a minority interest discount. The percentage of control represented by the block transferred to the donee (including potential swing-vote value) as well as other financial data and factors effecting the fair market value of the transferred stock must be included in the valuation for gift tax purposes. (Emphasis supplied).
b. *See also,* Tech. Adv. Mem. 9436005 and the discussion, *supra,* regarding the application of a swing vote premium.


a. Tech. Adv. Mem. 9719001. The donor created three trusts for the benefit of his children. Each trust was further subdivided into three more trusts. Therefore a total of nine trusts were in existence. The donor contributed a block of stock in a publicly traded company to the trusts. The donor argued that this was a gift of one block of stock, or in the worst case, a gift of 3 smaller blocks of stock. The Service ruled that, although the trusts could have been structured so that there was a total of only three separate gifts, one trust for the benefit of each grandchild, the donor chose the form of transfer, thereby creating nine separate trusts and nine separate gifts. Consistent with the form chosen, the donor reported nine separate gifts on the gift tax return. The Service concluded that, for purposes of applying the blockage discount in valuing the gifts, the transfers by the donor will be treated as nine separate gifts, each consisting of $\frac{1}{9}$ of the block of stock. Each separate $\frac{1}{9}$th gift of shares is considered separately as to its effect on the market to determine whether any discount is applicable.

b. Treas. Reg § 25.2512-2(e) provides that, if several gifts of blocks of the same stock are made to different donees on the same day, the blockage discount rule must be applied separately to each block, and not to the total of shares given away that day. Thus, the blockage discount rule is applied separately to each block, and not to the total of shares given away that day. The Service ruled that gifts to an individual, and to a trust for that individual, may be aggregated in applying the blockage discount rule. *See,* Priv. Let. Rul. 8049015.

5. *Estate of Bosca v. Commissioner,* T.C. Memo 1998-251 (1998). The decedent owned 50% of the voting stock of a closely held corporation. The decedent's two sons each owned 25% of the voting stock and 50% of the non-voting stock. The corporation's capital structure was recapitalized and the father exchanged his 50% voting stock for non-voting stock. As a result of the recapitalization, the two sons owned 100% of the voting stock. The Tax Court held that the father's exchange of the voting stock for non-voting stock was a "deemed" gift of the difference in value between the voting stock transferred to the corporation and the non-voting stock received. The silver lining to the dark cloud of *Bosca* is that the Tax Court correctly ruled that the "deemed" gift should be valued as two separate 25% gifts, as opposed to a gift of a 50% block.

1. Assets are valued for estate tax inclusion purposes based upon the value of the assets included in the decedent's estate. Assets are valued for estate tax deductibility purposes based upon the value of the property interest passing in a manner that qualifies for the estate tax marital or charitable deduction. The often cited example of this principle is the decedent who owns 100% of the stock of a closely held business worth $10,000,000. The decedent leaves 50% of her estate to her husband in a manner that qualifies for the estate tax marital deduction under Code § 2056 and 50% of her estate to a charity which qualifies for the estate tax charitable deduction under Code § 2055. The stock is included in the decedent's estate at $10,000,000; however, for estate tax deduction purposes, each 50% interest may be discounted for lack of marketability and lack of control. Assuming a combined 35% discount, the value of the marital deduction is determined as follows: (50% x $10,000,000) x (1 - 35%) = $3,250,000; the charitable deduction is determined similarly. Therefore, with a gross estate of $10,000,000 and combined estate tax marital and charitable deductions of $6,500,000 ($3,250,000 + $3,250,000), there is a taxable estate of $3,500,000. See, Pennell, "Valuation Discord: An Exegesis of Wealth Transfer Tax Valuation Theory and Practice", 1996 U. Miami Philip E. Heckerling Inst. Est. Planning § 9.02.

2. Ahmanson Foundation v. United States, 706 F.2d 1424 (7th Cir. 1983). The decedent owned 100% of the stock of a holding company with 1 voting shares and 99 non-voting shares. The decedent left the 1 voting share to his son and the 99 non-voting shares to a charity. The Court refused to value the voting and non-voting stock separately in the gross estate. The Court found that 100% of the stock should be valued for inclusion purposes, and then a 3% reduction should be applied to the value of the non-voting shares passing to charity. The reduction in the value of the assets passing to charity had the effect of reducing the charitable deduction and increasing the taxable estate.

3. Chenoweth v. Commissioner, 88 T.C. 1577 (1987). The decedent owned 100% of the stock of a closely held corporation. The decedent specifically bequeathed 51% of the stock to his wife, with the balance passing to his daughter from a prior marriage. The decedent's estate claimed a 38.1% control premium applied to the 51% block of stock, which under Florida law, gave the surviving spouse complete control over the corporation.

a. The Court was persuaded by the reasoning in Ahmanson and concluded that a control premium should be applied to the value of the 51% block of stock passing to Mrs. Chenoweth.

b. Interestingly the court noted the following:
While we would tend to agree that the sum of the parts cannot equal more than the whole -- that is, that the majority block together with the control premium, when added to the minority block of the company's stock with an appropriate discount for minority interest, should not equal more than the total 100% interest of the decedent, as reported for purposes of section 2031 -- it might well turn out that the sum of the parts can equal less than the whole - - that is, that the control premium which is added to the majority block passing to decedent's surviving spouse might be less than the proper minority discount to be attributed to the shares passing to decedent's daughter.

4. Tech. Adv. Mem. 9005004. This Ruling is essentially the reverse of Chenoweth. In this case, the decedent left 49% in trust for his wife and 51% in trust for his son. The Service ruled that the value of the interest passing to the marital trust should be valued as a separate interest in property and could, therefore, be subject to a minority interest discount. This will have the effect of reducing the marital deduction and increasing the value of the taxable estate.

5. Tech. Adv. Mem. 9403005. At the time of his death, the decedent owned a block of 400 preferred shares in a closely held corporation and a block of 37,728 common shares. Together, the two blocks of stock represented control of the corporation; separately they represented non-controlling interests. The decedent left the preferred stock to his wife and the common to his children. The Service ruled that "[i]f, as in the present case, a minority interest block of stock passes to the surviving spouse, a marital deduction may be taken for only for the value of the block as such. However, in accordance with the holdings in the Ahmanson and Chenoweth cases, the value of the same property for purposes of inclusion in the gross estate under Code § 2031 may be different if the decedent, at the time of death, possessed a controlling interest block of stock.

6. Estate of DiSanto v. Commissioner, T.C. Memo 1999-421 (1999). The decedent owned a controlling interest in a closely held corporation that he left to his wife. His wife disclaimed her right to inherit a certain amount of the stock, the result being that the only asset in the decedent's residuary estate that the wife could inherit was a minority interest in the stock. The Tax Court, relying on Chenoweth, held that the estate must compute the value of the marital deduction based on the minority interest the spouse was entitled to receive after she executed the disclaimer, not based on the value of the controlling interest he willed to her.
7. *Schwan v. Commisioner*, T.C. Memo 2001-174. Alfred Schwan, founder of a frozen food company, left 2/3rds of the voting and non-voting stock to a private foundation. The shares were subject to a redemption agreement with the Company. The Tax Court held, at a summary judgment hearing, that while the interests may be aggregated for inclusion purposes, for deduction purposes, the interests may be valued separately. Consequently, there may be a mismatch between valuation for inclusion and deduction purposes and additional tax may be due.

C. Aggregation of Interests.

1. In some cases, property may be included in the gross estate under separate estate inclusion provisions. For example, a decedent may own 30% of the stock of a closely held business in a revocable trust and 30% of the stock outright. The stock held in the decedent's revocable trust is includible in her estate under Code § 2038. The 30% interest owned outright is includible in her estate under Code § 2033. The question that arises is whether the two interests, includible under two separate provisions of the Code, should be valued separately or aggregated for valuation purposes. If the two 30% blocks of stock are valued separately, a minority interest discount may be warranted. If the two 30% blocks of stock are aggregated to form a 60% block, a control premium may be warranted.

2. The aggregation of interests theory is typically applied in the estate tax context. Nevertheless, practitioners should be cognizant of its application when planning gifts to family members and structuring the ownership of assets during lifetime.

3. Aggregation of Non-QTIP Property.

a. In Rev. Rul. 79-7, 1979-1 C.B. 294, the Service ruled that (i) a 30% stock interest transferred by the decedent within three years of death (includible in the gross estate under the former provisions of Code § 2035) and (ii) a 30% stock interest owned by the decedent at the time of his death (includible in the gross estate under Code § 2033) should be aggregated for valuation purposes, thereby disallowing a minority interest discount.

b. In Tech. Adv. Mem. 8330004, the Service ruled that the decedent was granted a general power of appointment in a trust when he was granted the option to purchase the stock from the trust on extremely favorable terms. The Service, relying on Rev. Rul. 79-7, also ruled that the stock includible in his estate under Code § 2041(a)(2) must be aggregated with the stock of the same corporation includible in his estate under Code § 2033 in determining its fair market value.
c. In Tech. Adv. Mem. 9403002, the Service ruled that (i) a block of stock held in the decedent's revocable trust and includible in his gross estate under Code § 2038 and (ii) a block of stock owned by the decedent outright and includible in his gross estate under Code § 2033 should be aggregated for valuation purposes. See, also, Estate of Babbitt v. Commissioner, 87 T.C. 1270 (1986).

4. Aggregation of QTIP Property and Other Property.

a. Estate of Bonner v. Commissioner, 84 F.3d 196 (5th Cir. 1996). The decedent died owning fractional shares in several pieces of real property with the remaining ownership interests being held in a QTIP trust established by his wife at her death. The executor of the decedent's estate applied a 45% discount in valuing the separate fractional interests. The Commissioner argued that the fractional interests in the real property should be aggregated for valuation purposes. The Fifth Circuit, relying on its prior holding in Estate of Bright, concluded that the fractional interests in the assets should not merge into a 100% fee ownership by the estate. The court stated that "the statute does not require, nor logically contemplate that in so passing, the QTIP assets would merge with other assets." The court also relied on the decedent's lack of control over the disposition of property. The Bonner court stated:

The estate of each decedent should be required to pay taxes on those assets whose disposition that decedent directs and controls, in spite of the labyrinth of federal tax fictions. . . . Mrs. Bonner controlled the disposition of her assets, first into a trust with a life interest for Bonner and later to the objects of her largesse. The assets, although taxed as if they passed through Bonner's estate, in fact were controlled at every step by Mrs. Bonner, which a tax valuation with a fractional interest discount would reflect. At the time of Bonner's death, his estate did not have control over Mrs. Bonner's interests in the assets such that it could act as a hypothetical seller negotiating with willing buyers free of the handicaps associated with fractional undivided interests. The valuation of the assets should reflect that reality.

b. Estate of Mellinger v. Commissioner, 112 T.C. 4 (1999). At the time of her death, the decedent owned 27.8671% of the issued and outstanding stock of Frederick's of Hollywood, Inc. The decedent predeceased husband established a QTIP trust for her benefit that also contained 27.8671% of the issued and outstanding stock of
Frederick's of Hollywood, Inc. Mrs. Mellinger's estate valued the two blocks as minority interests and applied a 31% discount. The Service attempted to aggregate the two blocks of stock in Mrs. Mellinger's estate to form a 55.7342% controlling block. In an extremely well-written and well-reasoned opinion, the Tax Court found nothing in the statute or the regulations that (i) the decedent should be treated as the owner of QTIP property for valuation purposes or (ii) that QTIP assets should be aggregated with other property in the estate for valuation purposes. The Tax Court noted that such a result would be inconsistent with the general system of estate tax inclusion since, unlike the provisions of Code §§ 2035, 2036, and 2041 which require estate tax inclusion where the decedent retains the power of disposition or control over the assets, at no time did Mrs. Mellinger possess, control, or have any power of disposition over the Frederick's of Hollywood shares in the QTIP Trust. The Tax Court reviewed the legislative history of Code § 2044(c) and found nothing to suggest that the surviving spouse should be treated as the owner of QTIP property or that such QTIP property be aggregated with any other assets included in the decedent's estate under Code § 2033.

c. Estate of Nowell v. Commissioner, T.C. Memo 1999-15 (1999). On the same day that the Tax Court decided Estate of Mellinger, the Tax Court ruled in Estate of Nowell v. Commissioner. The issue in Nowell was virtually identical to the issue in Mellinger – whether certain partnership interests included in the gross estate pursuant to Code § 2044 should be aggregated, for valuation purposes, with partnership interests in the same partnerships includible in the decedent's gross estate under Code § 2038. The Tax Court, relying on its decision in Mellinger, rejected the Commissioner's arguments and did not aggregate the interests.

d. Estate of Lopes v. Commissioner, T.C. Memo 1999-225 (1999). The Commissioner attempted, as it did in Mellinger and Nowell, to argue that the fractional interests in real estate held in a QTIP Marital Trust should be aggregated with the fractional interests in the same parcels of real estate includible in the surviving spouse's estate. The Tax Court, in a motion for summary judgment, observed that it had already "rejected the same aggregation argument advanced by [the Commissioner] in Estate of Mellinger and in Estate of Nowell v. Commissioner. We find no factual or legal distinction that would result in a different conclusion in this case."

e. Action on Decision 1999-006, 1999-35 I.R.B. 314. Given the strong analysis and logic employed by the Mellinger court, followed
by the rapid-fire succession of Nowell and Lopes, it was not particularly surprising that the Commissioner acquiesced in the decision in Mellinger. In Action on Decision 1999-006, the Commissioner acquiesced in the result of Mellinger. The AOD states:

[W]e agree with the Tax Court's opinion that closely-held stock held in a QTIP trust should not be aggregated, for valuation purposes, with stock in the same corporation held in a revocable trust and includable in the decedent's gross estate. The Tax Court's decision in this case is consistent with the Service's position regarding the valuation of minority interests passing to QTIP trusts. The proper funding of the QTIP trust should reflect, for example, the value of minority interests in closely-held entities or fractional interests in real estate that are used in satisfying the marital bequest. Cf. Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987); see also Rev. Rul. 84-105, 1984-2 C.B. 197.

f. For a more detailed discussion, see, Aghdami, "Valuation Discount Opportunities After Mellinger, Nowell and Lopes", Probate & Property, March/April 2000.

IX. USING ENTITIES TO MAXIMIZE VALUATION DISCOUNTS.

A. Introduction.

1. One of the publicized benefits of using a limited partnership or limited liability company (LLC) to transfer wealth to younger family members is the potential reduction in the value for transfer tax purposes of the assets being transferred because of valuation discounts for lack of control and lack of marketability.

2. For example, if an older family member desires to transfer to a younger family member 10% of his or her IBM stock worth $1,000,000, a direct transfer of the actual shares to the younger family member or to a trust for his or her benefit would be a taxable gift of $100,000.

3. On the other hand, if the older family member transferred the $1,000,000 worth of IBM stock to an LLC and received all the LLC interest in exchange (assuming the LLC is formed in a state that recognizes a single-member LLC) and he or she then gives a 10% interest in the LLC to the younger family member, the value of the gift for gift tax purposes may be less than $100,000. How much less will depend on the lack-of-control and
lack-of-marketability discounts a business appraiser would attribute to a 10% interest in an LLC owning IBM stock worth $1,000,000.

4. The following example illustrates the difference between the value of an interest in an entity whose going concern value is higher than its liquidation value and an interest in an entity for which the opposite is true:

Assume there are two limited partnerships with the same liquidation value: one owns an interest in an office building that has a fair market value of $1,000,000 and the other owns a hardware store that could sell its assets for $1,000,000. The office building produces an annual cash flow of $50,000, after taking into account expenses, including interest and principal payments. The hardware store produces $200,000 a year of cash flow. If an investor is seeking a 10% return on investment, he or she would be willing to pay $50,000 for a 10% interest in the office building, even though 10% of the value of the underlying assets would be $100,000. Absent any right to cause an immediate liquidation of the entity or to redeem his or her interest for a pro rata share of the asset value, the greater liquidation value of the office building is less important than its going concern value to the purchase decision. Of course, the actual price paid will also reflect the investor's expectations regarding the likelihood that the entity would be liquidated, entitling him or her to 10% of the appreciated value of the office building. On the other hand, an investor would not likely pay $200,000 for a 10% interest in the entity operating the hardware store, even though such an amount would generate the desired return based on the store's cash flow. The actual amount the investor would pay would turn on the minority owner's lack of control over liquidation and distribution decisions and the interest's lack of marketability.

5. In most estate planning situations involving real estate and other passive investments, including marketable securities, the value of the underlying assets is usually worth more than the value of the entity as a going concern. Therefore, a restriction on the right of an owner to cause a liquidation of the entity or to have his or her interest redeemed at a price equal to a pro rata share of the value of the entity's assets will be important in ensuring that the interest is entitled to a lack-of-control discount, assuming the restriction is not disregarded for federal transfer tax purposes.

B. Valuing Interests Held in Specific Entities.

1. Desirable characteristics for claiming lack-of-control 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.

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

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

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

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

   d. Code § 2036(b), which requires inclusion of shares of stock in a closely held corporation in the estate of the transferor who retains the right to vote the shares;

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

   f. Code § 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;

   g. Code § 2703, which ignores a right or restriction for valuation purposes if it is not commercially reasonable;

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

   i. Code § 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.

C. Corporations.
1. The amount of valuation premium or lack-of-control discount attributable to an interest in a corporation is directly related to the percentage of voting stock one owns and the rights such ownership percentage carries under state law.

   a. For example, for a corporation whose going concern value exceeds its liquidation value, a higher premium will apply to the ownership of more than two-thirds of the voting stock than to the ownership of less than two-thirds if state law requires a vote of more than two-thirds of the shares to liquidate the corporation. See, Virginia Code § 13.1-742.

   b. Furthermore, a premium will apply to the ownership of more than 50% of the voting stock if the owner can thereby control the election of the corporation's board of directors. See, Virginia Code § 13.1-669.

2. If the value of the underlying assets of a corporation exceeds the going concern value, there should be no premium applied to a majority or controlling interest. However, a minority or non-controlling interest will be entitled to a valuation discount.

3. A shareholder of a corporation does not have a right to have his or her interest redeemed under state law unless there is an agreement giving him or her such a right.

4. A shareholder of a corporation has the right to transfer his or her interest to a third party without any restriction unless there is an agreement imposing restrictions on transferability.

D. Limited Partnerships.

1. In the case of a limited partnership, valuation issues will differ for general and limited partners.

   a. An individual who owns only a limited partnership interest will have no right to participate in the management of the partnership, regardless of how much of an interest he or she holds. See, Virginia Code § 50-73.24.

   i. For example, in a limited partnership with a 1% general partner and a 99% limited partner, the general partner has the sole legal right to control the day-to-day affairs of the partnership. However, as a practical matter, an individual who owns 99% of the partnership interests as a limited partner may be in a position to exercise effective control over the 1% general partner. As the limited partner's percentage of the partnership declines and the number of
other limited partners increases, his or her effective control may also diminish.

b. A limited partner in a limited partnership, depending upon state law, also may not have a right to have his or her interest redeemed until the end of the term of the limited partnership as set forth in the certificate of limited partnership. Setting such a term in the certificate of limited partnership could therefore trigger a lack-of-control discount for limited partnership interests. There is a possibility, though, that the Service could view the term as an "applicable restriction" under Code § 2704(b) (although this would be an extreme expansion of the section's reach) and ignore it for valuation purposes. Some states have avoided this issue by specifically depriving a limited partner of a right to withdraw from the partnership, thereby ensuring that the restriction will be factored into the limited partnership interest's value. Code § 2704(b)(3)(B). See, Virginia Code § 50-73.38 (1999).

c. A limited partner does not have the right to transfer all his or her ownership rights in the partnership to a third party without the consent of some or all of the other partners, depending upon state law. See, Virginia Code § 50-73.45 (2000).

2. A general partner may be entitled to have his or her interest redeemed by the partnership at any time, although he or she may be subject to liability for a premature withdrawal.

a. However, in a family-controlled limited partnership, the potential liability may be disregarded as an applicable restriction under Code § 2704(b) for purposes of valuing the general partnership interest.

b. In partnerships with more than one general partner, any one general partner would no longer have control, but would still have the right to have his or her interest redeemed.

c. If a general partner in a limited partnership also owns a limited partnership interest, the issue arises as to whether he or she can cause the partnership to redeem both his or her general partnership interest and limited partnership interest.

d. A general partner does not have the right to transfer all his or her ownership rights in the partnership to a third party without the consent of some or all of the other partners, depending upon state law.
E. Limited Liability Companies (LLCs).

1. In a member-managed LLC, a member will have control under the default rule of most state LLC statutes if he or she owns more than 50% of the membership interests entitled to vote. See, Virginia Code § 13.1-1022.

2. However, in most states voting and nonvoting membership interests can be created so that nonvoting membership interests can be given to younger family members to achieve the same lack-of-control reduction in value achievable in a corporation through nonvoting stock.

   a. Because the special valuation rule in Code § 2704(b) applies only to liquidation rights, and not to voting rights, giving nonvoting membership interests to younger family members should depress the value of the membership interests for transfer tax purposes.

   b. In a manager-managed LLC, a non-member-manager's interest should be worth proportionately less than a member-manager's interest because only the managers have a right to participate in the management of the LLC.

3. A member of an LLC may or may not have a right to have his or her interest liquidated depending upon state law. See, Virginia Code § 13.1-1032.

4. In most states a member of an LLC cannot transfer all his or her ownership rights to a third party without the consent of some or all of the remaining members, depending upon state law. See, Virginia Code §§ 13.1-1039 and 13.1-1040.

F. Entities Holding Marketable Securities.

1. Assuming that 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.

   a. The family partnership rules under Code § 704(e) may disregard for federal income tax purposes a partnership that is valid under state law if certain criteria are not satisfied.

2. Congress recognized that a partnership owning only marketable securities was valid for federal tax purposes when it amended Code § 731(c) in 1994 to address the tax treatment of partnership distributions of marketable securities. Pub. L. No. 103-465, tit. VII, § 741(a), 108 Stat. 5006 (1994).

   a. Before its amendment, Code § 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.

   b. On the other hand, a partner did recognize income if cash was distributed and the cash exceeded his or her basis in the partnership.

   c. 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. Code § 731(c)(1)(A).

   d. 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 was still a partnership for federal tax purposes. Code § 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. 3773. ("It is acknowledged that certain partnerships are formed for the purpose of holding marketable securities for investment or for sale to customers.")

3. 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. Code § 761(a).

   a. A partnership holding only marketable securities should qualify as a financial operation.

   b. 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. Code § 761(a).

   c. 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 in the first place.
4. *Estate of Winkler v. Commissioner* suggests that the Tax Court may find that a valid partnership exists for tax purposes, regardless of the type of assets it holds. T.C. Memo 1997-4 (1997). 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 based on an analysis of the facts under the family partnership rules and the broad definition of partnership that appears in Code § 761(a). Finally, Treasury Department regulations under Code §§ 701, 704, and 761 include discussion of partnerships that are created solely for investment purposes. See Treas. Reg. §§ 1.701-1(a); 1.704-3(a)(3); and 1.761-2(a).

5. *Estate of Jephson v. Commissioner*, 87 T.C. 18 (1986). The decedent owned all of the shares of two investment companies whose assets consisted of two unleveraged portfolios of bonds, common stocks, and certificates of deposits. The cost of liquidating the companies on the valuation date would have been some $94,000. The stock was valued for estate tax purposes by applying discounts to reflect lack of marketability. The discount was determined by reference to the net asset value of 10 publicly traded closed-end investment funds with similar portfolios. The Tax Court determined that the values of the companies were their net asset values, less liquidation expenses. The Court based its finding on the fact that all of the companies' assets were liquid assets, that neither corporation had any significant liabilities, and that the decedent's 100 percent interests gave her the unqualified right to liquidate the companies. The court rejected the estate's attempt to claim a minority interest discount by analogizing the companies to publicly traded, closed-end investment companies. The court noted that in contrast to the instant case, an investor in a publicly traded firm "has little or no say" in the company's choice of an investment advisor or portfolio.

6. *Dailey v. Commissioner*, T.C Memo 2001-263 (2001). The decedent formed a family limited partnership that was funded with $1,000,000 of Exxon stock. The Tax Court rejected the IRS's arguments and allowed a 40% discount based on lack of marketability, lack of control, liquidity, and unrealized capital gains.

G. Investment Company Rules.
1. Transfers of property to certain entities considered "investment companies" can result in income taxation to the transferor. To avoid the recognition of gain on a transfer of appreciated securities to a partnership or LLC, the transfer must not be treated as a transfer to an investment company as described in Code §§351 or 721(b). Under Code §351(e)(1) transfer of property will be considered a transfer to an investment company if: (i) the transfer results directly or indirectly in diversification of the transferor's interest; and (ii) the transferee is a corporation, partnership or LLC where more than 80% of the value of the assets are held for investment and are cash, stocks or securities (whether or not readily marketable).

2. A corporation or partnership will be considered an investment company if:
   a. The contribution had the effect of diversification of the investor's assets (diversification generally results if two or more persons contribute non-identical assets to the same entity); and
   b. The transferee was (i) an entity classified as a regulated investment company, (ii) an entity classified as a real estate investment trust, or (iii) an entity in which more than 80% of the value of the assets were held for investment and were marketable securities.

3. For example, assume "A" and "B" form a partnership. "A" contributes $100,000 of a publicly traded stock in one corporation and "B" contributes $100,000 of stock in a different publicly traded company. Here, both tests would be met and the partnership would be considered an investment company. First, diversification of the partners' investments is deemed to have occurred through combining their assets in an entity in which they each now have a right to 50% of the partnership's various assets rather than a right to the individual stocks that they contributed. Second, marketable securities constitute greater than 80% of the assets contributed. As a result, "A" and "B" must recognize gain as if their respective stocks were sold by them to the partnership at the stock's fair market value.

4. Prior to the Taxpayer Relief Act of 1997 (TRA '97), marketable securities were defined as stock in securities traded on a securities exchange or regularly traded or quoted on the over-the-counter market. Under new Code §351(e), contributions of property to a corporation and partnerships that were non-taxable under pre-TRA '97 may now result in taxable gain due to the expansion of the definition of "securities". The term "marketable securities" has now been replaced with a term "stock and securities." Instead of limiting the 80% test to marketable securities, additional classes of property are now treated as "stock and securities" for purposes of this test. Under the new definition, items such as money, closely held stock, debt instruments, options, future contracts, foreign
currency and interest in precious metals are considered together with marketable securities in determining whether an entity is an investment company.

5. Under the Treasury Regulations for Code §351, there are exceptions to the general rule that diversification results when non-identical assets are transferred to an entity by one or more persons. Under one exception, if the amount of non-identical assets contributed constitutes an insignificant or de minimis portion of the total value of the assets contributed, the insignificant securities are disregarded in determining whether diversification has occurred. Although the regulations do not specify what exact amount will be considered "insignificant" or "de minimis", the example provided in the regulations indicates that less than 1% constitutes a de minimis amount.

6. For example, taxpayers A and B contributed $10,000 worth of the same class of stock in a publicly traded corporation in exchange for 50 shares each of a new corporation. Taxpayer C then contributed $200 of other marketable securities in exchange for one share of the new corporation. C's contribution of securities worth $200 represents a 0.99% of the total assets contributed. While it is true that A and B have had some diversification to their investment through the contribution by C, the regulations indicate that C's contribution of less than 1% is considered insignificant and, thus no diversification would result. The regulations do not say whether diversification would have been present if C's contribution had equaled or exceeded 1%.

7. The diversification issue may also be avoided if marketable securities contributed to an entity are already diversified in the hands of its contributors. This is often referred to a "multi-stock exception." For example, the multi-stock exception would apply if partners form a new partnership to which each partner contributed mutual funds. Since these securities are already in a diversified portfolio, diversification would not occur upon funding of the partnership. A portfolio will already be diversified if (i) not more than 25% of the value of the assets contributed by each transferor are securities of one issuer; and (ii) not more than 50% of the assets contributed by each transferor are securities of five or fewer issuers.

8. This new definition of "securities" may have a serious impact on the initial funding of FLPs and FLCs. Prior to the passage of TRA '97, transferors could avoid the investment company status by transferring real estate or closely held business interests with marketable securities so that the marketable securities constituted less than 80% of the entity's assets. However, under the new definition of securities, closely held business interests will constitute a "security" under the 80% test. If the family does
not own significant non-securities, such as real estate, then forming a
family partnership without incurring income taxation may be a challenge.
One option is to qualify for the de minimis exception by having one
family member contribute more than 99% of the assets and for the others
to contribute a total of less than 1%. Likewise, the multi-stock exception
should be considered. The change in the expansion of the definition of
securities will apply to all transfers made after June 8, 1997.

C. IRS Initiates Attacks On Family Limited Partnerships. In 1997, the Service
initiated its attack on FLPs and LLCs through a series of Technical Advice
Memoranda. See, e.g., 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). The TAMs involved situations where (a) liquid assets, such as marketable
securities, were transferred to a limited partnership or LLC; (b) the transferor was
elderly; and (c) the transfer was carried out by third parties (such as children) as
agents under a power of attorney or as trustees.

D. The Service’s Arguments. The Service has advanced the following arguments in
challenging the use and validity of FLPs, each of which will be discussed in
greater detail, below:

1. Disregarding the entity.
2. Code § 2703.
3. Code § 2704.
4. Gift upon formation.
5. Code § 2036.
7. Indirect gifts.

X. TAXPAYER VICTORIES.

A. Disregarding the Entity.

1. The Service’s Argument. The Service claimed that the formation of an
FLP should be treated as a single testamentary transaction and therefore
disregarded for transfer tax purposes. The Service cites 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. T.C. Memo 1990-472. 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%.

2. *Church v. United States* 268 F.3rd 1063 (5th Cir. 2001), aff'g per curiam 85 AFTR2d 2000-804 (W.D. Tex. 2000) suggests that threshold for a validly formed partnership is extremely low. The taxpayer formed a limited partnership two days before her death.

a. The corporate general partner had not been formed prior to her death, the limited partnership certificate had not been filed with the state, and assets had not been validly transferred to the partnership. Mrs. Church transferred $1.5 million of assets (real estate and marketable securities) to the partnership; her partnership interests were valued at $617,600.

b. The Service argued that Church did not effectively convey the securities to the partnership before she died. Alternatively, the Service also argued that Church made a taxable gift when forming the partnership, represented by the difference between the value of the assets she contributed and the value of the partnership interest she received.

c. The District Court ruled in the estate’s favor, rejecting the government’s arguments. As to the securities, the court found that Church did not hold legal title; she had an equitable beneficial interest because legal title was held by a brokerage house. Further, the court found that Church clearly expressed her intent to relinquish her beneficial interest when she executed the partnership agreement. On the gift issue, Judge Garcia wrote that the government’s argument “confuses the market value of the assignee interest passing at death with the value of the Partnership interest Mrs. Church received in return for her contribution. The two interests are not comparable. More importantly, the Government ignores the fact that this was a pro rata partnership that did not confer a financial benefit on, or increase the wealth of, any partner.” Furthermore, the court found that there was no donee and no gratuitous transfer. Judge Garcia also held that the partnership was not a sham as the government contended, finding that the partnership had bona fide business purposes and was not formed to reduce estate taxes. The court noted that Church did not have the unilateral right to amend or revoke the partnership agreement and that the partners had no express or implied agreement that Church could continue to use or possess partnership property within the meaning of Code § 2036.

B. Code § 2703.

1. **Statutory Language.** Under Code § 2703(a), for purposes of estate, gift, and generation-skipping transfer taxes, the value of any property is determined without regard to any right or restriction relating to the property. Code § 2703(b) states that a right or restriction will not be disregarded if the following requirements are met:

   a. The right or restriction is a bona fide business arrangement;

   b. The right or restriction is not a device to transfer the property to the natural objects of the transferor’s bounty for less than full and adequate consideration in money or money’s worth; and

   c. At the time the right or restriction is created, the terms of the right or restriction are comparable to similar arrangements entered into by persons in an arms-length transaction.

2. **The Service’s Argument.** The Service argues that the use of a partnership structure to hold assets is, in and of itself, a restriction with respect to the property and should be disregarded. The Service also argues that the exceptions to Code § 2703(b) should not apply because the use of a partnership is a “device to transfer property” for a less than full and adequate consideration.

3. Strangi I, 115 T.C. 35 (2000), the decedent’s son-in-law, acting pursuant to a power of attorney formed a family limited partnership funded largely with marketable securities. The decedent owned a 99% limited partnership interest and 47% of the corporate general partner. The Court found that the decedent retained effective control over the partnership. Nevertheless, the Court ruled that the decedent formed a valid partnership and that Code § 2703(a)(2) did not operate to disregard the limited partnership. See also, Church, 268 F3d 1063 (5th Cir. 2001).

4. However, consider a recent District Court case from the Western District of Pennsylvania, Smith, 94 AFTR2d 2004-5283 (W.D.Pa. 2004) which held that Code § 2703(a) applied to a provision in a limited partnership agreement which restricted the transferability of the interest. The Court, however, held that the question of whether the taxpayer could avail itself of the exception found Code § 2703(b) was a question of fact that required
The Court granted partial summary judgment on the Code § 2703(a) issue, but deferred on the Code § 2703(b) issue.

C. Code § 2704.

1. **Statutory Language.** Code § 2704(b) provides that an "applicable restriction" on the right of a donee to liquidate his or her interests may be disregarded for gift and estate tax purposes, thereby increasing the value of the gift or the size of the federal gross estate. An "applicable restriction" is a limitation on the ability to liquidate or dissolve the entity (in whole or in part) that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction.

2. **The Service’s Argument.** The Service contended that under Code § 2704(b) any limitations on the right to liquidate the interests that were more restrictive than the state’s default rule would be disregarded.

3. **Kerr v. Commissioner,** 292 F.3d 490 (5th Cir. 2002), affg 113 T.C. 443 (1999). The Tax Court held that a couple transferred limited partnership interests, not assignee interests, to two grantor retained annuity trusts (GRATs), but that they were entitled to apply liquidity discounts in valuing those interests because Code § 2704(b) did not apply. The Fifth Circuit affirmed that the Tax Court properly held the dissolution and liquidation provisions in the partnership agreements were no more restrictive than the limitations under Texas law, and weren’t applicable restrictions.

4. **Harper v. Commissioner,** T.C. Memo 2000-202 (2000). The analysis employed by the Tax Court in Kerr was adopted by Judge Wells in Harper, a family limited partnership case involving marketable securities, where the decedent’s revocable trust held 99% limited partnership and her two children collectively held a 1% general partnership interest.

D. **Gift Upon Formation.**

1. **The Service’s Argument.** The Service has argued that, if valuation discounts are appropriate in valuing limited partnership interests, the value that is “lost” by the taxpayer is a deemed gift of an equivalent amount to the other partners. For example, assume a taxpayer gifts an asset having a value of $1,000,000 to an FLP. The 99% limited partnership interest is discounted by 35%. The Service argues that the reduction in value of the taxpayer’s 99% limited partnership interest, as compared to its aliquot share of the underlying assets, constitutes a gift of $350,000, an amount equal to the amount of the reduction. See, e.g., Estate of Trenchard v.

2. **Taxpayer Arguments.**
   
a. The gift tax is an excise tax on the privilege of *transferring* property; it is an excise tax on the *transfer*, not on the subject of the gift. Treas. Reg. §§ 25.2511-2 and 25.2511-1(h)(1). Before the gift tax can be assessed, a transfer and a transferee must exist. On creation of a partnership, no person becomes a transferee, and without a transferee, there is no basis for the assessment of the gift tax.

b. Value appears and disappears and that fact does not mean that a transfer has occurred from one person to another. If A, B, and C each contribute $100 to form a corporation and receive 1 share of stock in return, the value of A’s stock is presumably valued at less than $100 because A does not possess the right to liquidate the corporation and receive a return of his investment. This diminution in value does not mean that A has made a taxable gift to his children, B and C. There is no transfer to B and C. B and C’s shares are also valued at less than $100.

3. The Service has been largely unsuccessful with respect to the gift upon formation argument. See, e.g., Jones v. Commissioner, 116 T.C. 11 (2001), Church v. United States 268 F.3d 1063 (5th Cir. 2001), Kerr v. Commissioner, 292 F.3d 490 (5th Cir. 2002), Shepherd, 115 TC 376, aff’d 283 F3d 1258 (11th Cir. 2002) and Strangi I, 115 T.C. 35 (2000).
XI. CODE § 2036.

A. Statutory Provisions. Code § 2036(a) provides as follows:

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

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

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

B. The Service’s Argument Under Code § 2036(a)(1).

1. The Service has been most successful under Code § 2036(a)(1) involving the retention of “possession or enjoyment” of property. Retention of possession or enjoyment may take place by express or implied understanding, and need not be under a legally binding agreement.

2. The Service has been successful in cases where the following “bad facts” were present:

   a. Most of a decedent’s assets were transferred to the partnership, without sufficient assets remaining outside of the partnership for the decedent’s needs.

   b. The decedent’s continued occupancy of a residence transferred to the partnership without contemporaneous payment of rent.

   c. Commingling of personal and partnership assets.

   d. Disproportionate distributions.

   e. Use of partnership funds for personal expenses.

   f. Timing of distributions, where partnership distributions were based on the decedent’s personal needs.

3. The “Bad Facts” cases are discussed in greater detail in Section IV, infra.
C. The Service’s Argument Under Code § 2036(a)(2).

1. In *Strangi*, the Service argued under Code § 2036(a)(2) that the decedent retained a right in conjunction with other persons to designate the persons who will enjoy the property or the income therefrom.

2. Taxpayers and their counsel, up to that time, relied on the decision of the U.S. Supreme Court in *Byrum* to shield them from Code § 2036(a)(2).

3. Code § 2036(a)(2) and *Strangi* are discussed in greater detail in Section V, *infra*.

D. The Exception for a “Bona Fide Sale for an Adequate and Full Consideration.”

1. Taxpayers have had mixed results in arguing that the exception for a “bona fide sale for an adequate and full consideration” should shield them from the application of Code § 2036.

2. The cases that have considered the bona fide sale exception are discussed in greater detail in Section VI, *infra*.

XII. THE “BAD FACTS” 2036(a)(1) CASES.


1. 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. Afterwards, she deposited income from the partnerships in her personal account, in which she deposited income from other sources, and used the account to pay her personal expenses as well as partnership expenses.

2. The Service once again argued that the limited partnership interests should be disregarded based on its Code § 2703 analysis. However, the Tax Court decided that the transferred interests should be included in the decedent’s estate under Code §§ 2036(a) and 2038 and decided the case in favor of the Service without invoking Code § 2703.

3. 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 Code § 2036(a)(1). The *Schauerhamer* case points out 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 the property transferred to the entity will not be includible in the transferor's estate under Code §§ 2036(a) and 2038.


1. The Tax Court held that property transferred by an individual to a family limited partnership was includible in his gross estate because he retained possession and enjoyment of it, and the right to its income.

2. In June 1993, shortly after having been diagnosed with terminal cancer, Charles formed a revocable living trust and a family limited partnership. He appointed himself and his children as cotrustees and authorized each trustee to act on behalf of the trust. The trust was the partnership's only general partner. Charles transferred all of his property (except for his car, personal effects, and a small amount of cash) to the partnership, including the property in which he had a life interest. He signed deeds individually and on behalf of his wife's estate transferring property to the trust and then signed deeds as trustee transferring the property to the partnership. He deposited over $20,000 of partnership funds to his personal checking accounts. He lived in one property before and after he transferred it to the trust and partnership. No rent was paid to the trust or partnership for use of the residence. Charles gave each of his two children a 30.4% interest in the partnership on October 22, 1993. He died on August 21, 1994 and his estate did not include any of the assets transferred to the trust and partnership. It did include his 34.46% limited partnership interest and his 1% general partnership interest.

3. The Service determined that the assets transferred to the partnership should have been included in his estate.

4. The Tax Court noted that, for purposes of Code § 2036, a transferor retains the enjoyment of property if there is an express or implied agreement at the time of the transfer that the transferor will retain the present economic benefits of the property, even if the retained right is not legally enforceable. The Tax Court found that Charles did not curtail his enjoyment of the transferred property after he formed the partnership. It said that nothing changed except legal title. Charles managed the trust which managed the partnership. He was the only trustee to sign the articles of limited partnership, the deeds, the transfer of lien, and any document which could be executed by one trustee on behalf of the trust. He was the only trustee to open brokerage accounts or sign partnership checks. Furthermore, the Tax Court found that Charles commingled partnership and personal funds. He deposited some partnership income in his personal account and he used the partnership's checking account as his personal account. He lived at the same property without paying rent before or after
he transferred it to the trust and to the partnership.

5. The estate maintained that Charles’ fiduciary duties as a general partner and trustee precluded him from retaining enjoyment of the assets. The Tax Court disagreed. It said that these duties did not deter Charles from continuing to possess and enjoy the house in which he lived or the other assets he conveyed to the partnership. The court also stressed that the children, as co-trustees, did nothing to preclude him from doing so. This suggested to the court that Charles and his children had an implied agreement to allow him to continue to enjoy partnership property for life. The estate also argued that Charles received full and adequate consideration for the transferred property. The court disagreed, finding that the children gave nothing to Charles or the partnership when he transferred property to the trust.


1. The taxpayer formed a family limited partnership. However, the taxpayer failed to observe all of the formalities of the partnership, commingled funds, etc.

2. The Court reviewed four missteps by the taxpayer: (1) commingling of funds, (2) the delay in transferring assets to the FLP, (3) a history of disproportionate partnership distributions, and (4) the testamentary characteristics of the arrangement. The Court concluded that Code § 2036(a) applied and that all discounts should be disallowed.

3. The Tax Court’s view of these cases is instructive: “Hence we are again met with an example of indifference by those involved toward the formal structure of the partnership arrangement and, as a corollary, towards the degree of separation that the Agreement facially purports to establish ... we find equally compelling indicia of an implied understanding or agreement that the partnership arrangement would not curtail decedent’s ability to enjoy the economic benefit of assets contributed to HFLP ... decedent did not divest himself economically of the contributed assets ... We additionally take note of decedent’s advanced age, serious health conditions and experience as an attorney.”


1. The decedent, received three significant properties from the estate of her deceased husband. The decedent’s children, her guardians and guardians ad litem entered into a court-approved plan to rearrange the decedent’s financial affairs to reduce estate taxes. The plan required that the three properties be transferred to three family limited partnerships, each having a corporate general partner the stock of which would be owned by a trust
for the decedent. The children were not to receive partnership income until the general partner had set aside sufficient sum to pay for the partnership’s administration and the support of the decedent. The corporate presidents (the decedent’s guardians ad litem), ran the partnerships, acting in a fiduciary capacity for the decedent, and they had complete discretion to determine how much money decedent needed from the partnerships to meet her needs. The decedent initially held a 98-percent limited partnership interest in two of the partnerships, the corporate general partners each held a one-percent interest, and one of the decedent’s daughters each held a one-percent interest. The decedent initially held a 99-percent limited partnership interest in the other partnership, and the corporation held the remaining 1-percent. The decedent later gave 30 percent limited partnerships to three of her children, two in exchange for cash transfers and the third in exchange for the settlement of certain claims.

2. The Service stated that the value of the properties was includible in the decedent’s gross estate under Code § 2036(a), because the decedent had retained the lifetime income and beneficial enjoyment of those assets. The court stated that the decedent continued to enjoy the right to support and maintenance from all the income of the partnerships, because the decree that authorized the creation of the partnerships stated that the decedent’s needs for support were contemplated first from the partnership income, and only thereafter, could the children receive their proportionate shares of income from the partnerships. The decedent’s support needs were actually treated as an obligation of the partnerships. The court also noted that one of the decedent’s children admitted the existence of a pre-arrangement to maintain the status quo with respect to her mother’s financial situation.

3. The First Circuit recently affirmed the Tax Court’s decision in Abraham.


1. The decedent became the limited partner of a family partnership. The decedent retained a 99.95 percent capital interest in the partnership and a 75-percent profits interest, and she gave her brother, Marc, the remaining interests as general partner. The decedent contributed seven properties to the partnership, though she did not actually change the title to the properties or formally assign to the partnership the leases on the properties for five months. The agreement allowed the decedent’s brother to act for the partnership without disclosing the existence of the partnership, and he did, in fact, do so. The partnership was "designed generally to be invisible to the public and to persons with whom the decedent and [Marc} Hillgren did business." The partnership agreement stated that the partnership need not have a separate bank account, and that it could use the accounts of the decedent’s revocable trust and proprietorship. Initially, the partnership
records included among its assets the decedent’s residence, and the partnership paid the mortgage and property taxes on that residence. An adjusted journal entry posted after the decedent’s death removed the residence and related expenses from the partnership’s books. There were no minutes of meetings of the partners and the certificate of limited partnership was not filed with the Secretary of State until nearly two years after the decedent’s death. The decedent’s brother, as the general partner, had sole discretion regarding partnership distributions, and during the five months that the partnership existed during the decedent’s lifetime, all distributions were made to or for the benefit of the decedent; none were made to the brother. The distributions were made in amounts to enable the decedent to pay her living expenses, and she was dependent on the partnership cashflow to cover those expenses. The partnership also paid the costs of the decedent’s estate, including estate tax installments. The partnership assets were managed by a corporation all of whose business was managing properties owned by various entities controlled by the decedent’s family. The same person managed the properties before and after the formation of the partnership. The decedent and her brother did enter into a business loan agreement covering four of the seven properties held by the partnership. The agreement was a complex document that included a contract for services provided by decedent’s brother, who facilitated forbearance and extensions of other loans, an agreement for the brother’s personal guarantee of certain loans, an agreement extending a $1 million line of credit to the decedent, and a security agreement encumbering three properties. The business loan agreement gave the brother authority, for 29 years, to determine whether to sell any of four properties subject to the agreement, and granted him an irrevocable power of attorney for duration of her ownership of properties. The decedent’s estate reported the decedent’s 99.5 percent partnership interest at $2,266,000, based on an independent appraisal that claimed discounts for lack of control and marketability.

2. The Tax Court agreed with the Service that the value of the partnership assets should be included in the decedent’s gross estate under Code § 2036(a), with no discounts for the existence of the partnership itself. In particular, the court noted that: (a) the proximity of the creation of the partnership to the death of the decedent (five months), and the fact that the decedent had earlier attempted suicide and did, in fact, die by suicide, suggests that the transaction was testamentary in nature; (b) the management of the assets remained the same both before and after creating the partnership, suggesting an agreement to retain the beneficial enjoyment of those assets; (c) the argument that the partnership was created as a premarital asset protection device fails, because the decedent broke up with her boyfriend and apparent marriage candidate before the creation of the partnership [The court also noted that the estate made “inconsistent representations during discovery and during trial” regarding
whether the boyfriend was even aware of the partnership; (d) there was no solid evidence that the decedent and her brother negotiated at arm’s length over the terms of the partnership or the contributions of services to be made by the brother; (e) the decedent’s brother was both general partner of the partnership and trustee of the decedent’s revocable trust, that held the decedent’s interest in the partnership; (f) the brother ignored the terms of the partnership agreement when “it suited him”; (g) funds were commingled; (h) the partnership form was ignored frequently; (i) the decedent’s psychiatrist testified that the decedent had not expected that the partnership would change her relationship with her brother or her role in the management of the partnership assets; (j) the decedent had planned to transfer her residence to the partnership; (k) the decedent received all of the partnership income distributions. The court held, however, that the business loan agreement was a bona fide contract that would be taken into account by any buyer of the four properties to which it related. The business loan agreement, the court stated, restricted the control over those properties and reduced their marketability, justifying discounts of 55 percent for one property, 35 to 40 percent for three others, and an additional five percent for lack of voting rights.

D. Estate of Wayne C. Bongard, (2005) 124 TC No. 8. The Tax Court held that stock in an operating company transferred by an individual to a holding company organized as a limited liability company (LLC) was not includible in his gross estate under Code § 2036(a) because the transfer was a bona fide sale for full and adequate consideration. However, the Court then held that membership units in the LLC transferred by the individual to a family limited partnership (FLP) were includible in his estate under Code § 2036(a). This transfer did not qualify for the sale exception and the Court found that there was an implied agreement whereby the individual retained an interest in the units transferred.

E. Estate of Virginia A. Bigelow, TC Memo 2005-65. The Tax Court held that rental real estate transferred from a decedent’s revocable trust to a family limited partnership (FLP) had to be included in her gross estate under Code § 2036(a) because she had retained, for her life, the right to the property’s rental income and its economic benefit under an implied agreement that the court found to have existed.

F. Estate of Edna Korby, et al. v. Commissioner, (2005) TC Memo 2005-103 Decedent’s gross estate included his proportionate share of marital assets transferred intervivos with wife to FLP: decedent retained lifetime right to assets’ income and economic benefit via implied agreement. Agreement evidence included facts that transfers left decedent and wife with insufficient income to pay even basic living expenses at time they were both facing serious ill health and medical expenses, and that they replaced lost income with partnership payments funneled through their trust; and, attempt to cast payments as fees for decedent’s asset management services was belied by lack of any management contract or
evidence that any real management activities were performed. Also, bona fide sale exception didn't apply in light of couple's retained income right and failure to follow partnership formalities.

G. Estate of Austin Korby, et al. v. Commissioner, (2005) TC Memo 2005-102. Decedent's gross estate included her proportionate share of marital assets transferred intervivos with husband to FLP: decedent retained lifetime right to assets' income and economic benefit via implied agreement. Agreement evidence included facts that transfers left decedent and husband with insufficient income to pay even basic living expenses at time they were both facing serious ill health and medical expenses, and that they replaced lost income with partnership payments funneled through their trust; and, attempt to cast payments as fees for husband's asset management services was belied by lack of any management contract or evidence that any real management activities were performed. Also, bona fide sale exception didn't apply in light of taxpayers' retained income right and failure to follow partnership formalities. And, parties agreed that marital deduction didn't apply.

XIII. CODE § 2036(a)(2) – STRANGI

A. Estate of Strangi v. Comm'r, 417 F.3rd 479 (5th Cir. 2005); aff'g T.C. Memo. 2003-145 (May 20, 2003), on rem'd from Gulig v. Comm'r, 293 F.3rd 279 (5th Cir., 2002), aff'g in part, rev'g in part, Estate of Strangi v. Comm'r, 115 T.C. 478 (2000).

1. Decedent’s son-in-law acting under a durable power of attorney, created a Texas family limited partnership and transferred to it most of the decedent’s personal and investment assets. Decedent received a 99-percent limited partnership interest and 47 percent of the stock of the corporate general partner. Decedent’s family owned 52 percent of the rest of the stock of the general partner, and an unrelated charity owned one percent of the stock. Decedent died two months later.

2. The Tax Court initially held that: (a) the creation of the partnership was not a taxable gift; (b) the partnership had economic substance; (c) the terms of the partnership agreement were not restrictions on the transfer the underlying assets, under Code § 2703(a)(2); and (d) the Service claim that the decedent had retained control over the transferred partnership assets was not raised in a timely manner. The Fifth Circuit affirmed the Tax Court on the substantive issues, but stated that the Service could argue the application of Code § 2036(a), because its motion was made early enough to prevent prejudice to the taxpayer.

3. On remand, the Tax Court held that the partnership assets transferred by the decedent were includible in his gross estate, because he had retained their beneficial enjoyment, under Code § 2036(a)(1). The court noted
particularly that: (a) the decedent was in very poor health when he established the partnership; (b) the partnership paid many of the decedent’s personal expenses, including personal in-home health care, surgery for the decedent’s care-giver, funeral expenses, estate administration expenses, and related debts of the decedent’s estate, and a specific bequest to the decedent’s sister (the court was not swayed by the partnership having treated these expenses as advances and having made corresponding distributions to the general partner, because the decedent’s 99.43-percent interest meant that no significant distributions were actually made to anyone else); (c) the decedent continued to live in his residence after transferring it to the partnership and the decedent only accrued rent that was not actually paid for more than two years; (d) the decedent’s 99.43 percent interest made the arrangement seem testamentary, rather than a true joint enterprise; and (e) the documents were forms provided by a private group, with little, if any, input from other family members.

4. The Tax Court also stated that the partnership assets could be included in the decedent’s gross estate under Code § 2036(a)(2), because he controlled their beneficial enjoyment. The court noted that the general partner could (i) unilaterally determine partnership distributions, and (ii) could, acting with the other partners, terminate the partnership and cause its assets to be distributed. The court noted that Regulations § 20.2036-1(b)(3) taxes a decedent with respect to powers that are exercisable only with the consent of others.

5. The Tax Court also rejected the estate’s reliance on United States v. Byrum, 408 U.S. 125 (1972), because: (a) the control was vested in someone who was the decedent’s son-in-law, his attorney, and his attorney-in-fact; (b) the partnership held primarily investment assets, whereas the corporations in Byrum were operating businesses whose ability to distribute dividends was subject to business exigencies not relevant to the Strangi partnership; (c) the other stockholders in Byrum were largely unrelated to the decedent; (d) there was an independent trustee in Byrum, who could decline to distribute to the beneficiaries any amounts distributed by the Byrum corporations; and (e) the fiduciary duties held by directors and shareholders in Byrum were not relevant in Strangi, because the few holders of other interests were unlikely to enforce them.

6. The Fifth Circuit held that the Tax Court properly concluded that Code § 2036 required a decedent's estate to include assets transferred by him during his life to a family limited partnership (FLP). The Fifth Circuit concluded that the record supported the Tax Court's conclusion that Strangi and the other shareholders of Stranco (i.e., the Strangi children) had an implicit agreement by which Strangi would retain the enjoyment of his property after the transfer to SFLP because:
a. SFLP distributed over $100,000 from '94 to '96 to pay for funeral expenses, estate administration expenses, specific bequests and various personal debts that Strangi had incurred. The Fifth Circuit said that these repeated distributions provide strong circumstantial evidence of an understanding between Strangi and his children that "partnership" assets would be used to meet Strangi's expenses.

b. Strangi continued to live in his residence after its transfer to SFLP. The estate responded by noting that SFLP charged Strangi rent on the home. The Fifth Circuit pointed out that although the rent charge was recorded in SFLP's books in '94, the estate made no actual payment until '97. The Appeals Court said that, even assuming that the late rent payment was not a belated attempt to recast Strangi's use of the house, such a deferral, in itself, provides a substantial economic benefit. Thus, the Tax Court did not err in considering Strangi's continued occupancy of his home as evidence of an implied agreement.

c. Strangi lacked liquid assets after the transfer to pay his living expenses.

8. As for the second argument, IRS conceded that the "adequate and full consideration" requirement was satisfied because Strangi received a proportional interest in the partnership in exchange for the assets he transferred to it and partnership formalities were followed. However, it argued that the transfer was not a bona fide sale and the Fifth Circuit agreed. The Appeals Court said that a sale is bona fide if, as an objective matter, it serves a substantial business or other non-tax purpose. In this regard, the Tax Court found that Strangi's transfer of assets to SFLP lacked a substantial non-tax purpose. While the estate proffered five discrete non-tax rationales for Strangi's transfer of assets to SFLP, the Tax Court rejected each of them as factually implausible. The Fifth Circuit held that these findings were not clearly erroneous. Thus, it held that the bona fide sale exception did not apply.

9. Unfortunately for practitioners, the Fifth Circuit, having resolved the case on the Code § 2036(a)(1) issue, did not answer the Code § 2036(a)(2) issue.
XIV. BONA FIDE SALE – FULL AND ADEQUATE CONSIDERATION EXCEPTION


1. The decedents, husband and wife, together created five family limited partnerships, to hold various businesses and investments that the decedents owned. The decedents had initially been drawn to the family limited partnership as a means of settling disputes among their children regarding the management of various assets, but their estate planning attorney had later explained to them how these devices could also reduce their estate tax liabilities. They created the five partnerships, in consultation with their children. Each of their children became a general partner, together with the parents, in one or more of the partnerships, and participated actively in the operations of the partnership. The children each contributed their own assets to buy their shares of the partnerships, though some of these assets had originally been given to the children by their parents. The parents’ attorney consulted with the attorneys for the children in selecting the terms of the partnerships, though the parents’ attorney drafted the agreements.

2. After both parents died relatively close together, the Service asserted that the value of the partnership assets should be included in the decedents’ estates under Code § 2036(a)(1), as a transfer with a reservation of beneficial enjoyment.

3. The Tax Court disagreed, and held that Code § 2036(a)(1) did not apply, because the decedents had transferred their assets to the partnerships in bona fide sales for adequate and full consideration. The court distinguished its contrary holdings in several other cases, noting that: (a) all of the partners transferred their own assets to the partnership in exchange for their proportionate interests, though some of those assets were the results of prior gifts from the decedents; (b) upon the termination or dissolution of each of the partnerships, the partners were entitled to distributions from each such partnership in amounts equal to their respective capital accounts; (c) each partner was represented in the decision-making by separate counsel; (d) the decedents retained enough assets outside the partnership to provide for their own needs and support; (e) creating the partnership was motivated at least partially by nontax business concerns; and (f) the decedents’ children became general partners and participated actively in managing the partnerships. Cf. Estate of Reichardt v. Comm’r, 114 T.C. 144 (2000), Estate of Thompson v. Comm’r, T.C. Memo.2002-246; Estate of Harper v. Comm’r, T.C. Memo.2002-121; Estate of Strangi v. Comm’r, T.C. Memo.2003-145.

1. Ruth A. Kimbell died in March 1998 at the age of 96. When she died, Mrs. Kimbell held interests in three entities: (1) the R.A. Kimbell Living Trust ("Trust"), (2) the R.A. Kimbell Management Co., LLC ("LLC"), and (3) the R.A. Kimbell Property Co., Ltd. ("Partnership"). Trust was created by Mrs. Kimbell in 1991 and fully revocable by her before her death. Thus, its interests and Mrs. Kimbell's interests were treated as one for tax purposes. Mrs. Kimbell and David Kimbell were co-trustees, and David Kimbell was paid a monthly fee to manage Trust. LLC is a Texas limited liability company established in January 1998. It was owned 50% by Trust, 25% by David Kimbell and 25% by his wife (Mrs. Kimbell's daughter-in-law). David Kimbell was the manager of LLC. Partnership is a Texas limited partnership created on January 29 1998 (two months before Mrs. Kimbell’s death) by Trust and LLC, which contributed 1% of the capital of Partnership and was its general partner. Trust contributed 99% of the capital and yet was only a limited partner. Partnership had a term of 40 years (i.e., until Mrs. Kimbell would have been 136 years old). As Mrs. Kimbell had a 50% interest in LLC through her ownership of Trust and a 100% interest in Trust, her real interest in Partnership was 99.5%.

2. After Mrs. Kimbell died, David Kimbell, as her executor, filed estate tax returns with the Service, which audited them and found that the value of Mrs. Kimbell’s 99% interest in Partnership was $2.463 million, not $1.257 million as reported. David Kimbell paid the increased taxes and ultimately went to district court seeking a refund of $837,089, claiming that the Service had overvalued the estate.

3. At the District Court, David Kimbell argued that Mrs. Kimbell’s transfer of assets to Partnership was a bona fide sale for an adequate and full consideration in money or money’s worth. The district court disagreed. It said there was no credible evidence that Partnership’s formation was the product of an arm’s length transaction between unrelated parties. The court said that there weren’t even two parties because ownership interests in Partnership were held by two entities: 99% by Trust, which was wholly-owned by Mrs. Kimbell, and 1% by the LLC, which was 50% owned by Trust. The court said that even if Partnership resulted from a bona fide sale, David Kimbell didn’t establish that Mrs. Kimbell received adequate and full consideration for the sale. Mrs. Kimbell, through Trust, contributed 99% of the capital for Partnership and in return received a 99% interest in Partnership. Mrs. Kimbell received no consideration other than the interest in Partnership. David Kimbell, before becoming the general partner of Partnership, was already managing both Trust, where 99% of the assets of Partnership came from and LLC from where the other 1% came from (of which 0.5% were from Trust). David Kimbell argued
that Mrs. Kimbell "irrevocably" transferred her assets to Partnership and thus qualified under the retained income or rights exception. The district court said that this argument didn't fly. Mrs. Kimbell (through Trust), although formally a limited partner, owned 99% of Partnership, and an additional 0.5% of Partnership through her 50% interest in LLC. Under the partnership agreement, Mrs. Kimbell, as a limited partner with a 99% interest in Partnership, could at any time remove the general partner, and either appoint herself or someone she chose to be the new general partner, who could then distribute the income back to Mrs. Kimbell. Thus, Mrs. Kimbell retained the right to the income from the property. Accordingly, the district court found the transfer to be includible in Mrs. Kimbell's estate under Code § 2036.

4. The Fifth Circuit said that for Mrs. Kimbell's transfer to Partnership to qualify as a bona fide sale, it had to be a sale in which she actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange. For the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate. In addition, when the transaction is between family members, it is subject to heightened scrutiny to ensure that the sale is not a sham transaction or disguised gift.

5. The Fifth Circuit concluded that Mrs. Kimbell's transfer was for full and adequate consideration because:

a. The interest credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to Partnership,

b. The assets contributed by each partner to Partnership were properly credited to their respective capital accounts, and

c. On termination or dissolution of Partnership the partners were entitled to distributions from it in amounts equal to their respective capital accounts.

6. The court in Kimbell noted with regard to the immediate decrease in value of the decedent's assets after the partnership was formed that, "The business decision to exchange cash or other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security, and
preservation of assets, capital appreciation, and avoidance of personal liability."

7. The sale was “bona fide” in Kimbell because:
   
a. The transferor actually parted with his interest in property transferred in exchange for a partnership interest. Put differently, the transferor did not use partnership assets in the same way both before and after the transfer.
   
b. Mrs. Kimbell retained sufficient assets outside of the partnership for her support. Partnership formalities were followed, and partnership assets were not used for personal expenses.
   
c. There were significant nontax reasons for the arrangement (and therefore it was not a disguised gift or sham). These included: (a) protection of Mrs. Kimbell from personal liability in connection with working oil and gas interests; (b) partnership assets could continue intact, and could be passed down to family members without being broken up; and (c) the arrangement provided centralized management and a mechanism to appoint successors to the decedent’s son, who was currently managing the partnership.

C. Turner v. United States, 382 F3d. 382 (3rd Cir. 2004).

1. The Third Circuit Court of Appeals held that the estate of an individual who transferred $2.8 million in securities and other assets to two family limited partnerships in exchange for pro-rata partnership interests had to include the full date of death value of the transferred assets under Code § 2036.

2. In 1993, Theodore Thompson, his daughter Betsy T. Turner, and her husband George Turner, formed the Turner Partnership and Turner Corporation. Mr. Thompson contributed $1,286,000 in securities, along with notes receivable from Betsy’s children totaling $125,000, in exchange for a 95.4% limited partnership interest in the Turner Partnership. George contributed $1,000 in cash and real property valued at $49,000 in exchange for a 3.54% limited partnership interest. Turner Corporation, the sole general partner, held the remaining 1.06% interest. Shares in Turner Corporation were issued to Mr. Thompson (490 shares or 49%), Betsy (245 shares or 24.5%), George (245 shares or 24.5%), and an unrelated tax-exempt entity (20 shares or 2%). Mr. Thompson and his son Robert Thompson formed the Thompson Partnership on April 30, 1993, and the Thompson Corporation on April 21, 1993. Mr. Thompson contributed $1,118,500 in securities, along with notes totaling $293,000, in exchange for a 62.27% limited partnership interest. Robert contributed
mutual funds worth $372,000, and a ranch property appraised at $460,000 in exchange for a 36.72% limited partnership interest. Thompson Corporation, as general partner, held the remaining 1.01% interest. Mr. Thompson and Robert each held 49% of Thompson Corporation and an unrelated third party held the remaining 2% interest. As of July 1993, Mr. Thompson, then age 95, had transferred $2.8 million in assets—$2.5 million in the form of marketable securities—to the Turner and Thompson Partnerships. He retained $153,000 in personal assets, and received an annual income of $14,000 from two annuities and Social Security. At the time of transfer, he had annual expenses of $57,202, and an actuarial life expectancy of 4.1 years.

3. The Turner Partnership assets consisted primarily of marketable securities contributed by Mr. Thompson, which the partnership continued to hold in his brokerage account with minimal post-transfer trading. The Turner Partnership engaged in several business transactions, although none produced economic gains. The Turner Partnership also made loans to members of the Turner family. Although the partnership formally charged family members interest on these loans, interest payments were often late or not paid at all, and loans were frequently reamortized. But the partnership never pursued enforcement action against any of its debtors nor made loans to anyone outside the Turner family. Like the Turner Partnership, most of the Thompson Partnership assets consisted of marketable securities contributed by Mr. Thompson and Robert Thompson and there was little post-transfer trading. In 1993, each partnership made cash distributions of $40,000 to Mr. Thompson which he used to provide holiday gifts to family members. In 1995, the Thompson and Turner Partnerships made cash distributions to him of $45,500 and $45,220 respectively. During the same time period, he made gifts of interests in both partnerships to individual family members. In March 1995, the Thompson Partnership distributed $12,500 to Mr. Thompson to pay for some personal expenses.

4. Mr. Thompson died on May 15, 1995. On May 27, 1995, the Turner and Thompson Partnerships respectively sold $347,000 and $350,000 in securities to partially fund bequests in his will and pay his estate taxes. Mr. Thompson’s estate tax return reported that he held a 87.65% interest in the Turner Partnership and a 54.12% interest in the Thompson Partnership valued at $875,811 and $837,691 respectively, and that his shares in Turner Corporation and Thompson Corporation were worth $5,190 and $7,888 respectively. The estate calculated these values by applying a 40% discount rate to the net asset value of the partnerships and corporations for lack of control and marketability.

5. In January 1999, the Service issued a notice of deficiency in the amount of $707,054, adjusting the taxable estate from $1,761,219 to $3,203,506 after
disallowing the claimed discounts. The estate went to Tax Court. In an amended answer to the estate’s petition, the Service contended that the full fair market value of the assets transferred by Mr. Thompson to the partnerships should be returned to his gross estate under Code § 2036(a) because he retained control and enjoyment over the transferred assets during his lifetime.

6. The Tax Court found that the family partnerships were validly formed and properly recognized for federal estate tax purposes but nevertheless included the transferred assets in the estate under Code § 2036(a). The Tax Court found an implied agreement existed at the time of transfer that Mr. Thompson would retain lifetime enjoyment and economic benefit of the transferred assets. In support of this finding, the Court noted that both Betsy and George Turner had sought assurances from financial advisors that Mr. Thompson would be able to withdraw assets from the partnerships to make gifts to family members, and that the partnerships in fact made such distributions to him. The Tax Court also determined that the transfers did not qualify for the full and adequate consideration exception because the transactions were not motivated by legitimate business concerns. According to the Tax Court, the family partnership was a mere “recycling of value” and Mr. Thompson’s receipt of a partnership interest in exchange for his testamentary assets was not full and adequate consideration.

7. After reviewing the record, the Third Circuit found no clear error in the Tax Court’s finding of an implied agreement between Mr. Thompson and his family that he would continue to be the principal economic beneficiary of the contributed property, which was sufficient to trigger Code § 2036(a)(1). The Third Circuit stressed that, as the Tax Court had found, Mr. Thompson did not retain sufficient assets to support himself for the remainder of his life, as calculated at the time of transfer. It said that this fact supported the implied understanding with the children. The Third Circuit said that Mr. Thompson’s *de jure* lack of control over the transferred property did not defeat the inference of an implied agreement under the circumstances of the case.

8. The Third Circuit also agreed with the Tax Court that there was no transfer for consideration within the meaning of Code § 2036(a). The Third Circuit stressed that neither partnership had engaged in any valid, functioning business enterprise. Although the partnerships did conduct some economic activity, these transactions did not rise to the level of legitimate business operations.

9. The Third Circuit also emphasized that the form of the transferred assets—predominately marketable securities—was significant to its holding. Other than favorable estate tax treatment resulting from the
change in form, the Court said that it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in a family limited partnership with no ongoing business operations. In short, the Third Circuit said that where the transferee partnership does not operate a legitimate business, and the record demonstrates that the valuation discount provides the sole benefit for converting liquid, marketable assets into illiquid partnership interests, there is no transfer for consideration within the meaning of Code § 2036(a).

10. The Third Circuit also concluded that there was no bona fide sale within the meaning of Code § 2036 because there was no discernible purpose or benefit for the transfer other than estate tax savings.

11. The Court implied that the case at hand was different from Kimbell, where the Fifth Circuit found that there was both full and adequate consideration and a bona fide sale for a transfer of assets to a family limited partnership where the transferred assets were working oil and gas interests and the transfer was motivated by a desire to achieve centralized management and protection from personal environmental liabilities.

D. **Estate of Charles Porter Schutt, et al. v. Commissioner**, TC Memo 2005-126. Code § 2036(a) and Code § 2038 didn't require inclusion in gross estate of stock transferred by decedent through revocable trust to 2 Delaware business trusts (DBTs): transfers qualified as bona fide sales for adequate and full consideration. Bona fide sales finding was supported by credible evidence that DBTs were formed by decedent and his related family trust co. primarily for legitimate non-tax purpose of preserving decedent's “buy and hold” investment strategy and protecting wealth tied up in core stockholdings. Other bona fide sales evidence included facts that stock was actually transferred, negotiations were held at arm's length, there was no commingling of assets, and decedent wasn't financially reliant on DBT distributions. And, adequate/full consideration was also shown by DBTs' foregoing non-tax purpose, plus facts that proportionate interests were received, capital accounts were properly credited, distributions would require negative capital account adjustments, and liquidating distributions would be made in accord with capital account balances.

E. See also, **Mirowski v. Commissioner**, T.C. Memo 2008-74 (2008), in which the Tax Court rejected the IRS's arguments under Code §§ 2036(a)(1), 2036(a)(2), 2038, and 2035.
XV. FAMILY LIMITED PARTNERSHIP UPDATE – RECENT AND REALLY RECENT DEVELOPMENTS.

A. IRS Appeals Settlement Guidelines.

1. In UIL No. 2031.01-00 (Oct. 20, 2006), the Service issued Appeals settlement guidelines on discounts and other key issues related to transfers of family limited partnership and family limited liability company interests ("FLP"). (The guidelines appeared in the January 31, 2007 issue of BNA’s Daily Tax Report.)

2. Background. Many taxpayers have transferred passive assets (such as marketable securities and cash) to FLP’s and LLCs as a means to involve younger generations in the investment decision-making process and to protect these assets from creditors and spouses of the taxpayers’ chosen beneficiaries. Because of the significant valuation discounts associated with FLP interests, the Service has aggressively challenged the use of FLPs in this context with varying degrees of success.

3. The Service initially challenged whether the FLP was a valid entity for tax purposes. In doing so, it applied theories such as substance over form, step-transaction analysis, and lack of business purpose to set aside the transaction for estate and gift tax purposes and include the full value of the assets in the decedent’s gross estate. However, the Courts regularly rejected these arguments unless the facts demonstrated that the taxpayers had not respected the FLP as an independent legal entity or otherwise treated the FLP assets if they belonged to the taxpayer.

4. When the FLP could not be set aside for tax purposes, the Service shifted its focus to lowering the valuation discounts claimed for lack of marketability and minority interest attributes.

5. The Service continues to be concerned with three areas of abusive practices in connection with FLPs. These are: 1) cases where the taxpayer treats the FLP assets as his own assets and/or pays personal expenses from the partnership; 2) cases where the taxpayer fails to follow the formalities of the FLP; and 3) cases where excessive discount is taken in valuing the FLP, especially when the FLP’s assets consist of stocks and bonds and other passive assets. In the Service’s view, “these practices are often tax-avoidance in nature, and therefore looked upon as tax shelters.”

6. Summary of Issues. The settlement guidelines address four issues. For each issue, the guidelines summarize the Service’s position, the taxpayer’s position, and provide a detailed discussion of applicable case law. Unfortunately, the specific criteria that the Appeals Officers are directed to focus on in their analyses have been omitted from public disclosure.
Notwithstanding, the guidelines provide an excellent summary of the current state of FLPs from the Service's perspective.

7. The four issues addressed in the guidelines are as follows.

a. Whether the fair market value of transfers of FLP interests, by death or gift, is properly discounted from the pro rata value of the underlying assets.

b. Whether the fair market value at date of death of Code § 2036 or Code § 2038 transfers should be included in the decedent's gross estate.

c. Whether there is an indirect gift of the underlying assets, rather than the FLP interests, where the transfers of assets to the FLP (funding) occurred either before, at the same time, or after the gifts of the limited partnership interests were made to family members.

d. Whether an accuracy-related penalty under Code § 6662 is applicable to any portion of a tax deficiency.

B. Estate of Korby. In Estate of Korby v. Commissioner, 2006 U.S. App. LEXIS 30087 (Dec. 8, 2006), the Eighth Circuit affirmed the Tax Court's holding that the value of an FLP was included in the decedents' estates under Code § 2036(a)(1).

1. Husband and wife funded an FLP with marketable securities worth roughly $1,850,000 in return for a 98% limited partnership interest, which they distributed equally to irrevocable trusts for the benefit of their four sons. These assets represented almost all of the couple's assets, except for their home, their right to receive social security checks, and various other assets which they retained in a living trust. When the couple died (within months of each other), the Service took the position that the full value of the FLP assets was includible in the couple's estates, and a deficiency of approximately $2.1 million was assessed.

2. As one would expect, the Tax Court agreed with the Service, and the Eight Circuit affirmed, based on the following factors:

a. Despite the couple's increasing expenses (due to medical reasons), they retained only their home and relatively few other assets. The FLP paid some of the couple's living expenses directly, and made significant payments to the living trust, which paid the balance of the expenses. Neither the Tax Court nor the Eighth Circuit bought the estates' argument that payments to the living trust were "management fees."
b. The bona fide sale for full consideration exception to Code § 2036 did not apply. In affirming this conclusion of the Tax Court, the Eight Circuit made the following statements (citing other Circuits):

i. A transfer is typically not a bona fide sale when the taxpayer stands on both sides of the transaction.

ii. The transaction must be made in good faith, requiring an examination as to whether there is potential benefit other than the estate tax advantages that might result from holding assets in a partnership.

iii. If there is no discernible purpose or benefit of the transfer other than estate tax savings, the sale is not “bona fide” within the meaning of Code § 2036.

C. Estate of Erickson. In Estate of Hilda E. Erickson et al. v. Commissioner, T.C. Memo 2007-107 (April 30, 2007), the Tax Court held that (1) the decedent had an implied agreement with the partners of a family limited partnership (“FLP”) that decedent could retain the right to possess or enjoy assets transferred to the partnership, and (2) the transfer of assets by decedent (acting through the decedent’s agent under a power of attorney) to the partnership in exchange for a pro rata limited partnership interest was not a bona fide sale.

1. The decedent in Erickson suffered from Alzheimer’s. Four months prior to decedent’s death, the decedent’s two daughters, as general partners, and the decedent (acting through one of her daughters as the decedent’s attorney-in-fact under a durable power of attorney), the decedent’s credit shelter trust (with the decedent’s daughter who was her attorney-in-fact signing as a trustee) and the decedent’s son-in-law, as limited partners, executed a limited partnership agreement. The partners delayed in funding the partnership. Shortly before the decedent’s death and with the decedent’s health rapidly failing, her attorney-in-fact daughter rushed to fund the partnership with most of the decedent’s liquid assets.

2. Decedent (acting through her daughter as her attorney-in-fact) made substantial gifts to her grandchildren of limited partnership interests only a few days before the decedent’s death. Following the decedent’s death, the partnership (1) purchased the decedent’s residence, (2) made loans to some of its partners, and (3) “redeemed” the limited partnership interest owned by the decedent’s estate. The executor of the decedent’s estate used the proceeds from the purchase by the partnership of the decedent’s residence and limited partnership interest to pay the decedent’s tax liabilities and administration expenses.
3. The Tax Court held that the value of the assets transferred to the partnership by the decedent’s daughter, as the decedent’s attorney-in-fact, were includible in the decedent’s gross estate under Code § 2036(a)(1). The Tax Court reasoned that the decedent made an implied agreement with the other partners to retain possession and enjoyment of the assets transferred to the partnership. The Court noted that the possession and enjoyment of one’s assets includes the assurance that the assets will be available to pay debts and expenses after death. The Court found the following facts especially troubling evidence of an implied agreement:

a. The partners delayed transferring assets to the partnership.

b. The estate needed liquid funds from the partnership to meet its liabilities.

c. The partnership had little practical effect during the decedent’s life.

d. The decedent made substantial gifts of limited partnership interests a few days before her death.

e. The decedent had declining health from the inception of the partnership.

4. The Tax Court also held that the transfer of assets to the partnership was not a bona fide sale that would exempt it from inclusion under Code § 2036(a)(1). Although the Court noted that the decedent received a pro rata partnership interest in exchange for the transfer of assets, it held that the estate failed to show that the partnership was formed for a legitimate and significant nontax reason. The estate offered the testimony of both daughters to demonstrate the various non-tax purposes for the partnership (creditor protection, centralized management, facilitating gift gifting, etc.).

5. However, the Court rejected these reasons espoused by the daughters, in light of 1) the delay in funding, 2) the estate’s dependence on the partnership to help pay the estate’s liabilities and 3) the almost unilateral nature of establishing the partnership (one of the two daughters acted in various capacities in signing the partnership agreement).

6. As with most 2036(a)(1) cases, Erickson presented “bad facts” that ultimately led to estate tax inclusion. In that regard, its holding does not add anything new to the 2036(a)(1) line of cases. However, the Court’s reasoning for rejecting the creditor protection benefits of the partnership merits a brief mention. The court held that “[a] creditor who sought funds from the Partnership, however, would have a significant asset base from which to recover from the Partnership, over $2 million.” Yet, the creditor protection at issue was not, as the Court suggested, for claims against the
partnership (which a creditor clearly could satisfy from the partnership assets), but rather for claims against the individual partners (which, if the partnership were structured appropriately, could not be satisfied from the underlying assets of the partnership).

D. Estate of Gore. As in Erickson, the Tax Court in Estate of Sylvia Gore, et. al. v. Commissioner, T.C. Memo 2007-169 (June 27, 2007) rejected a poorly funded and administered FLP structure and included the assets transferred by the decedent to the partnership in the decedent’s gross estate.

1. In Gore, the decedent purported to withdraw assets from a marital trust established by her deceased husband and then transfer the assets to a limited partnership. The capital accounts in the partnership were then to be allocated in equal shares to the decedent’s revocable trust and to irrevocable trusts for the decedent’s two children.

2. Although the decedent executed an “assignment” document, the actual titling of assets was not transferred to the partnership until after the decedent’s death. Moreover, the decedent continued to receive interest and dividend income from the assets purportedly assigned to the partnership.

3. The Court held that, under applicable state law, the decedent had effectively withdrawn assets from the marital trust based on the execution of the assignment document. However, the Court held that the decedent had not effectively transferred to the partnership the assets that she had withdrawn from the marital trust and, therefore, included the marital trust assets under Code §§ 2033 and 2036(a). The Court reasoned that based on the retention of powers and interest in these assets, the decedent continued to exercise ownership, dominion, and control over the marital trust assets until her date of death. The Court pointed to an unbelievable lack of attention to the formalities in funding and administering the partnership and rejected partnership accounting records prepared by the decedent’s C.P.A. long after the fact that attempted to “properly” characterize the activities surrounding the partnership.

E. Estate of Bigelow. Similarly, in Estate of Bigelow v. Commissioner, 2007 U.S. App. LEXIS 22030 (September 14, 2007), the Ninth Circuit affirmed the Tax Court’s holding that real property transferred to an FLP was includable in the gross estate of the decedent/transferor (the “decedent”), because an implied agreement existed between the decedent and her children that the decedent would retain income and economic enjoyment from the transferred asset.

1. In affirming the Tax Court, the Ninth Circuit also held that the parenthetical “bona fide sale for adequate and full consideration” exception in Code § 2036(a) did not apply.
2. In Bigelow, the decedent created a revocable trust (the “trust”) and transferred her interest in her principal residence to the trust. The decedent and her son (who also acted as her attorney-in-fact) were the trustees of the trust. The trust then exchanged the residence for rental property. In order to repay two existing mortgages on the residence, the trust obtained a loan secured by the rental property (the “loan”). The trust also obtained a line of credit (the “line of credit”) secured by the rental property. The line of credit subsequently was drawn down by the trust, in part to make cash gifts to the decedent’s children and grandchildren.

3. The trust then contributed the rental property to an FLP; however, the $450,000 in loan/line of credit liabilities were not transferred to the FLP and remained liabilities of the trust, for which the decedent was personally liable. Although the partnership agreement did provide that the transferred rental property would be encumbered by the loan and line of credit, the decedent agreed to hold the partnership harmless for these obligations.

4. Despite decedent’s personal obligation to make the loan payments, the partnership made each payment (the trust made payments toward the line of credit). The decedent’s capital account, however, was not reduced to reflect these payments until after her death, and at that time, the account was reduced only to reflect the extent to which the payments were applied to loan principal, even though most of the payments (especially in the beginning) were applied to interest.

5. The FLP also paid some of the decedent’s living expenses, and there were forty transfers of funds between the trust and the FLP within a 28 month period. Furthermore, before creation of the FLP, the decedent’s monthly cash flow was $950. After creation of the FLP, the decedent had a monthly shortfall of $1,200. This shortfall eventually grew to $4,800 per month after the decedent’s long-term care insurance expired.

6. Not surprisingly, the Ninth Circuit held that the decedent maintained cognizable economic benefit from the property she transferred to the FLP, because she and her children maintained an implied agreement that she would have access to income from the property. The court based its conclusion on the following bad facts:

   a. When the decedent transferred the rental property to the FLP, the liabilities associated with the property (i.e., the loan and the credit line), were not transferred;

   b. The FLP made payments on the loan and line of credit, but the decedent’s capital account was not debited until after her death, and at that time, the payments applied to interest were not reflected;
c. The decedent’s children knew that her long-term care insurance was set to expire. Further, the children testified that they never intended to provide for the decedent with their own money, but they were committed to her care and maintaining her standard of living. In the absence of an expectation that the FLP would supplement the decedent’s monthly income as necessary, however, the transfer of her major asset to the FLP would have impoverished her; and

d. The partnership formalities were not observed.

7. The court then considered whether the transfer of the property to the FLP was a “bona fide sale for adequate and full consideration” within the meaning of Code § 2036(a). The decedent’s estate urged the court to adopt the three pronged test for “adequate and full consideration” set forth by the Fifth Circuit in Kimbell, 371 F.3d 257 (5th Cir. 2004): 1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership; 2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners; and 3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

8. The Bigelow court conceded that the inter vivos transfer of real property to an FLP that inherently reduces the fair market value of the resulting partnership interests does not “per se” disqualify the transfer from the Code § 2036(a) exception. The court, however, stated that the estate must demonstrate more than a proportional exchange and show a “genuine” pooling of assets. The court also emphasized that the question of whether adequate and full consideration exists cannot be gauged independently from the non-tax-related business purpose involved in creating the FLP (and of course, intra-family transfers automatically are subject to heightened scrutiny). Ultimately, the transaction at issue in Bigelow was not executed in good faith, because 1) the transfer resulted in the decedent becoming impoverished; 2) the partnership formalities were not respected; and 3) the transfer did not create a potential non-tax benefit for the decedent. The lesson here is that if a client transfers his or her primary income-producing asset to an FLP, it will be difficult, if not impossible, to argue down the road that there was a legitimate, non-tax reason underlying the transaction.

F. See also, Mirowski v. Commissioner, T.C. Memo 2008-74 (2008), in which the Tax Court rejected the IRS’s arguments under Code §§ 2036(a)(1), 2036(a)(2), 2038, and 2035.
XVI. OTHER AREAS OF CONCERN.


1. In 1995 and 1996 Albert and Christine Hackl gave their children and grandchildren membership units in Treeco, a limited liability company that Albert formed to hold and operate tree farming properties. When Albert bought the timberland, he sought to provide investment diversification in the form of long-term growth and future income. The land he bought had little or no existing salable timber. Albert and Christine gave interests in the company to family members in 1995. The couple reported the gifts on their gift tax returns and elected to treat them as made one-half each by Albert and Christine under Code § 2513. They also treated the gifts as qualifying for Code § 2503(b)'s $10,000 annual exclusion. The couple continued the gifting program in 1996, but transferred membership units in Treeco to their minor grandchildren’s trust. The couple treated the 1996 gifts as they had the 1995 gifts. At the time of the gifts, Albert correctly anticipated that Treeco and several successor entities would generate losses and make no distributions for many years. The IRS disallowed the exclusions for 1996.

2. The Tax Court, deciding in the Service’s favor, noted that the dispute turned on whether the transfers amounted to gifts of a present or future interest. Because the gifts failed to confer substantial present economic benefit by reason of use, possession, or enjoyment of the property or the income from the property, the court concluded that they failed to qualify for the Code § 2503(b) exclusion. In reaching its decision, the court rejected the Hackls’ argument that when a gift takes the form of an outright transfer of an equity interest in property, no further analysis is needed or justified. The court held that to follow this logic was to sanction exclusions for gifts based only on “conveyancing form,” without inquiring into whether the donees received rights that differed from those that would have come from a traditional trust arrangement. In examining the facts and circumstances of the Hackls’ case, the court held that any economic benefit the donees could have ultimately obtained from their receipt of Treeco units was future, not present.

3. The Tax Court based its decision primarily on the terms of the LLC Operating Agreement. The terms discussed by the Tax Court included the authority given to Mr. Hackl as manager, the inability of members to withdraw their capital accounts, the inability of members to sell interests to outsiders, and the inability of members to compel distributions. The Court concluded, “…the terms of the Treeco Operating Agreement foreclosed the ability of the donees presently to access any substantial
economic or financial benefit that might be represented by the ownership units."

B. Indirect Gifts.

1. In *Senda*, T.C. Memo 2004-160, the donors (a husband and wife) created two FLPs (FLP I and FLP II). The donors signed the FLP I agreement on April 1, 1998. The partnership agreement provided that a .01% limited partnership interest was initially held in trust for each of the donors' three minor children. On December 28, 1998, the donors contributed 28,500 shares of MCI WorldCom stock to FLP I by transferring the stock from their joint brokerage account to the brokerage account of FLP I. By fax dated December 28, 1998, the donors informed their accountant that they had transferred stock to FLP I, and sought advice as to what percentage of partnership interests they should transfer to the children. On that same day, the husband gave each child (or trust for that child) a 29.94657% limited partnership interest in FLP I, and the wife gave each child (or trust for that child) a 0.0434% limited partnership interest in FLP I. The certificates of ownership reflecting the transfers were not prepared and signed until several years later.

2. The donors signed the FLP II agreement on December 17, 1999. As with FLP I, the partnership agreement provided that a .01% limited partnership interest was initially held in trust for each of the donors' three minor children. On December 20, 1999, the donors contributed 18,477 shares of MCI WorldCom stock to FLP II by transferring the stock from their joint brokerage account to the brokerage account of FLP II. On that same day, the donors gave to each child, in trust, a 17.9% limited partnership interest in FLP II. By fax dated December 22, 1999, the donors informed their accountant that they had transferred stock to FLP II, and sought advice as to the percentage of partnership interests they should transfer to the children to maximize their annual gift tax exclusions and use all of their remaining unified credits. On Jan. 31, 2000, the donors gave to each child, in trust, an additional 4.5% limited partnership interest in FLP II.

3. On their 1998, 1999, and 2000 gift tax returns, the donors reported the transfers as gifts of partnership interests to their children. The values of the partnership interests were determined by multiplying the value of the transferred stock (as to which there was no dispute) by the percentage of the partnership interests transferred to the children, and then applying lack of marketability and minority interest discounts.

4. The Service conceded that the Jan. 31, 2000 gifts were gifts of partnership interests, not gifts of stock. But the Service argued that the December 28, 1998 transfer of stock to FLP I, and the December 20, 1999 transfer of stock to FLP II, coupled with the transfer of limited partnership interests
to the donors' children, were indirect gifts of the stock to the children. Thus, the Service argued that the stock, not the partnership interests, had to be valued for gift tax purposes. According to the Service, "the transitory allocations to [the donors'] capital accounts, if such allocations even occurred at all, were merely steps in integrated transactions intended to pass the stock to the [donors'] children in partnership form."

5. The Tax Court agreed with the Service, saying that the donors had presented no reliable evidence that they contributed the stock to the FLPs before they transferred the partnership interests to their children. The court said that the donors were "more concerned with ensuring that the beneficial ownership of the stock was transferred to the children in tax-advantaged form than they were with the formalities of FLPs," and noted that the husband, as general partner, did not maintain any books or records for the partnerships other than brokerage account statements and partnership tax returns. The tax returns were prepared months after the transfers of the partnership interests, and thus were unreliable in showing whether the donors transferred the partnership interests to the children before or after they contributed the stock to the partnerships. The same was true of the certificates of ownership reflecting the transfers of the partnership interests, which were not prepared until at least several weeks after the transfers. And the letters that the donors faxed to their accountant after they had funded the partnerships did not establish—as the donors contended—that the donors first funded the partnerships and then transferred the partnership interests to their children. The faxes established only that the donors had funded the partnerships; they did not show what the partnership ownership interests were immediately before the funding, or how the stock was allocated among the partners' capital accounts at the time of the funding. The court concluded that the value of the children's partnership interests was enhanced upon the donors' contributions of stock to the FLPs. Thus, the transfers were indirect gifts of stock to the children.

6. In Holman v. Commissioner, 130 T.C. 12 (2008), the Tax Court rejected the indirect gift theory advanced in Senda. In this case, gifts of LP interests were gifted to children six days after the entity was formed. The LP held stock of Dell Computer. The Court found that the stock transfers were clearly made to the partnership in advance of the gift of the LP interests; in addition, the Court declined to apply the step-transaction doctrine to these transfers.

7. In Gross v. Commissioner, T.C. Memo 2008-221 (2008), the Tax Court again rejected the indirect gift theory. In this case, marketable securities were contributed to the FLP and interests were transferred to the taxpayer's daughters 11 days later. The Court focused on the real economic change in value of the underlying securities during the intervening 11 day period. It is noteworthy, that unlike marketable
securities, real estate or other long term assets may not change in value quite so quickly.

XVII. OBTAINING FINALITY WITH RESPECT TO VALUATION ISSUES.

A. Gift Tax Final Regulations.

1. On December 3, 1999, the Internal Revenue Service (IRS) issued final regulations relating to changes made to the Internal Revenue Code (Code) §§ 2001, 2504, and 6501 by the Taxpayer Relief Act of 1997 and the Internal Revenue Service Restructuring and Reform Act of 1998 regarding:

   a. The valuation of prior gifts in determining estate and gift tax liability; and

   b. The period of limitations for assessing and collecting gift tax. 64 Fed. Reg. 67767 - 67773

2. The principal changes made to the proposed regulations, which were issued on December 22, 1998 (63 Fed. Reg. 70701), are:

   a. The adequate disclosure requirement is satisfied if the information listed in the regulation is provided;

   b. If property is transferred to a trust, taxpayers may submit a complete copy of the trust document in lieu of a description of the trust terms;

   c. Only financial data that was used in valuing the transferred interest must be submitted;

   d. A statement of the fair market value of 100% of the entity is not required if the value of the interest in the entity is properly determined without using the net asset value of the entire entity;

   e. Information on lower tiered entities must be submitted only if the information is relevant and material in determining the value of the interest in the entity;

   f. An appraisal satisfying specific requirements in the regulations may be submitted in lieu of a detailed description of the method used to determine the fair market value and in lieu of information regarding tiered entities;

   g. The requirement of a statement of relevant facts that would apprise the Service of the nature of any potential gift tax controversy
concerning the transfer or a concise legal description of the legal issue presented by the facts is eliminated;

h. The taxpayer must only describe positions contrary to proposed, temporary or final regulations published at the time the transfer occurred;

i. In the case of split gifts between spouses, gifts attributed to the non-donor spouse are deemed to be adequately disclosed if the gifts are adequately disclosed on the return of the donor spouse;

j. Adjustments for legal as well as valuation issues are precluded once the gift tax statute of limitations expires; and

k. Completed transfers to members of the transferor's family in the ordinary course of operating a business are deemed to be adequately disclosed, even if not reported on a gift tax return, if the item is properly reported by all parties for income tax purposes.

B. **Gifts Before August 6, 1997.**

1. For estate tax purposes, in determining the amount of adjusted taxable gifts (which is added to the taxable estate for purposes of determining the estate tax), the value of a gift made before August 6, 1997 may be adjusted at any time, even though the statute of limitations has run on the assessment of a gift tax in connection with the gift.

   a. This rule also applies to adjustments involving issues other than valuation. Treas. Reg. § 20.2001-1(a).

2. For gift tax purposes, if a gift tax return is filed for a year, an assessment of a gift tax for any gifts made during that year, whether disclosed or not may not be made after the statute of limitations has run. Treas. Reg. § 25.2504-2(a).

   a. This rule only applies to gifts made before January 1, 1997. Treas. Reg. § 301.6501(c)-1.

   b. However, an adjustment in the value of any gifts made before August 6, 1997, whether or not disclosed, may be made in determining the prior taxable gifts of the taxpayer for calculating the gift tax on subsequent gifts unless a gift tax has been paid or assessed for the calendar year in which the transfer occurred. Treas. Reg. § 25.2504-2(a).

   c. In addition, adjustments involving issues other than valuation may be made, whether or not a gift tax has been paid. Treas. Reg. § 25.2504-2(a).

1. In determining the amount of a decedent's adjusted taxable gifts for estate tax purposes, a gift made after August 5, 1997 that was adequately disclosed on a gift tax return may not be revalued.

   a. While the proposed regulations limited this rule to adjustments involving valuation, and not adjustments involving other issues, such as whether the gift qualified for the annual exclusion, the final regulations apply this rule to all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law. Treas. Reg. § 20.2001-1(b).

2. For gift tax purposes, the value of a gift made after August 5, 1997 may not be adjusted after the statute of limitations has run if the transfer was adequately disclosed on a gift tax return. Treas. Reg. § 25.2504-2(b).

   a. While the proposed regulations limited this rule to adjustments involving valuation, and not adjustments involving other issues, such as whether the gift qualified for the annual exclusion, the final regulations apply this rule to all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law. Treas. Reg. § 25.2504-2(b).

   b. A gift made after December 31, 1996 but before August 6, 1997 is subject to the adequate disclosure requirements relating to the running of the statute of limitations, but is still subject to the rule that the gift can be revalued for determining adjusted taxable gifts even if a gift tax had been paid for a gift reported on a gift tax return for 1997.

3. The value of a gift is finally determined for gift tax purposes if:

   a. The value is shown on a gift tax return, or on a statement attached to the return, and the Service does not contest the value before the statute of limitations has run;

   b. The value is specified by the Service before the statute of limitations has run with respect to the gift and such specified value is not timely contested by the taxpayer;

   c. The value is finally determined by a court of competent jurisdiction; that is, when the court enters a final decision, judgment, decree or other order passing on the valuation that is not subject to appeal; or

   d. The value is determined pursuant to a settlement agreement entered into between the taxpayer and the Service that is binding
on both. A settlement agreement includes a closing agreement, a compromise agreement, or an agreement entered into in settlement of litigation involving the amount of the taxable gift. Treas. Reg. § 20.2001-1(c), (d).

D. Disclosure Requirements.

1. A transfer will be adequately disclosed on a gift tax return with respect to a transfer made after December 31, 1996, only if it is reported in a manner adequate to apprise the Service of the nature of the gift and the basis for the value so reported. Treas. Reg. § 301.6501(c)-1(f)(2).

2. Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed if the return or a statement attached to the return provides the following information:

   a. A description of the transferred property and any consideration received by the transferor;

   b. The identity of, and relationship between, the transferor and the transferee;

   c. If the property is transferred in trust, the trust’s tax identification number and a brief description of the terms of the trust or a copy of the trust instrument;

   d. A detailed description of the method used to determine the fair market value of property transferred, including:

      (1) Any relevant financial data.

      (2) A description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property.

      (3) In the case of a transfer of an interest that is actively traded, the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest quoted selling prices on the applicable valuation date.

      (4) In the case of a transfer of an interest in an entity (e.g., a corporation or partnership) that is not actively traded, a description of any discount claimed in valuing the entity or any assets owned by such entity.

      (5) If the value of the entity or interests in the entity is properly determined based on the net value of the assets held by the
entity, the taxpayer must demonstrate that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets or furnish:

(a) A statement regarding the fair market value of 100% of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity);

(b) The pro rata portion of the entity subject to the transfer; and

(c) The fair market value of the transferred interest as reported on the return.

(6) If the entity that is subject to the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the same information is required for each entity, if the information is relevant and material in determining the value of the interest.

(7) In lieu of the above information an appraisal of the transferred property that meets the following requirements:

(a) The appraisal is prepared by an appraiser who satisfies all the following requirements:

i) The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

ii) Because of the appraiser’s qualifications, as described in the appraisal that details the appraiser’s background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued; and

iii) The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee, as defined in Code §2032A(e)(2), or any person employed by the donor, the donee, or a member of the family of either; and
(b) The appraisal contains all of the following:

i) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal;

ii) A description of the property;

iii) A description of the appraisal process employed;

iv) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions;

v) The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value;

vi) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions;

vii) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred; and

viii) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

e. A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer.

3. Completed transfers to members of the transferor's family, as defined in Code § 2032A(e)(2) for purposes of the special valuation rules under Code § 2032A, that are made in the ordinary course of operating a business are deemed to be adequately disclosed, even if not reported on a gift tax
return, if the transfer is properly reported by all parties for income tax purposes.

4. Completed transfers, all or a portion of which are reported as not constituting a transfer by gift (other than a transaction in the ordinary course of business), will be considered adequately disclosed if the same information is provided as is required for a transfer that is treated as a gift, plus an explanation as to why the transfer is not a transfer by gift.

Treas. Reg. § 301.6501(c)-1(f)(2), (3), (4).

5. Adequate disclosure of a transfer that is reported as a completed gift on the gift tax return will start the running of the statute of limitations for assessment of gift tax on the transfer, even if the transfer is ultimately determined to be an incomplete gift.

a. For example, if an incomplete gift is reported as a completed gift on a gift tax return and is adequately disclosed, the period of assessment of the gift tax will begin running when the return is filed.

b. On the other hand, if the transfer is reported as an incomplete gift, whether or not adequately disclosed, the period for assessing a gift tax with respect to the transfer will not commence to run even if the transfer is ultimately determined to be a completed gift.

(1) In that situation, the gift tax with respect to the transfer may be assessed at any time, up until three years after the donor files a return reporting the transfer as a completed gift with adequate disclosure.

Treas. Reg. § 301.6501(c)-1(f)(5).

6. If a husband and wife elect split-gift treatment, the disclosure requirements are satisfied for the gift deemed made by the consenting spouse if the return filed by the donor spouse satisfies the disclosure requirements. Treas. Reg. § 301.6501(c)-1(f)(6).

E. Adequate Disclosure of Compensation to Family Members.

1. Completed transfers to members of the transferor’s family that are made in the ordinary course of operating a business are deemed to be adequately disclosed, under Treas. Reg. § 301.6501(c)-1(f)(2), even if the transfer isn't reported on a gift tax return, if the transfer is properly reported by all parties for income tax purposes.
2. For example, in the case of salary paid to a family member employed in a family-owned business, the transfer will be treated as adequately disclosed for gift tax purposes if the item is properly reported by the business and the family member on their income tax returns. See, Treas. Reg § 301.6501(c)-1(f)(4).

3. The exception only applies to transactions conducted in the ordinary course of operating a business. It doesn't apply, for example, in the case of a sale of property (including a business) by a parent to a child.

4. For example, A owns 100% of the stock of X Corporation, a company actively engaged in a manufacturing business. B, A's child, is an employee of X and receives an annual salary paid in the ordinary course of operating X Corporation. B reports the annual salary as income on B's income tax returns. During the year, A transfers property to family members and files a gift tax return reporting the transfers. But A doesn't disclose the salary payments made to B. Because the salary payments were reported as income on B's income tax return, the salary payments are deemed to be adequately disclosed. The transfer of property to family members, other than the salary payments to B, reported on the gift tax return must satisfy the adequate disclosure requirements under Treas. Reg. § 301.6501(c)-1(f)(2) in order for the statute of limitations to begin to run with respect to those transfers.
XVIII. DEFINED VALUE GIFTS.

A. The Internal Revenue Service will almost always scrutinize significant transfers of "hard-to-value" assets. Reasonable people (and, of course, unreasonable people) can differ on the value of certain assets (e.g., a family limited partnership interest). From the Service's point of view, scrutiny of those assets may represent a significant revenue opportunity.

B. One approach that may reduce the chance of an audit of a transfer of a hard to value asset, or a gift tax surprise if an audit does occur is to utilize a formula defined value transfer. A formula defined value transfer may increase the retained interest of the donor (as in the case of a grantor retained annuity trust); may define the portion of the property interest that is transferred or may provide that a defined portion of the property transferred passes to a "tax sheltered recipient."

C. For example, a transfer may provide that an undivided part of a "hard-to-value" asset, which exceeds a defined value of the transferred entity interest, will pass either to a grantor retained annuity trust, the transferor's spouse, charity or a trust in which the grantor has retained an interest that makes the gift incomplete.

D. The IRS argues that such clauses should not be respected because they would make fair administration of the gift tax difficult, given the Service's limited resources available for gift tax audits, especially considering the finality that now can be obtained through gift reporting with adequate disclosure under Code § 6501(c)(9).

E. "Formula defined value" clauses should be distinguished from "price adjustment" clauses like the ones discussed in Revenue Ruling 86-41, 1986-1 C.B. 442 and in Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944). In Rev. Rul. 86-41, the IRS said that a clause that increased the consideration to be paid for the transferred property or that caused a portion of the transferred property to revert to the transferor were conditions subsequent that are not effective to avoid a taxable gift from being made on the transfer of the property. By contrast, formula clauses defining the amount of the transfer or the identity of the transferee are ubiquitous in the transfer tax context. In fact, such arrangements are specifically permitted in the tax law. If an adjustment occurs in a formula defined value clause, a change in the identity of the transferee may occur (e.g., the credit shelter trust owns less of the asset and the marital trust owns more of the asset). If an adjustment occurs in a price adjustment clause, the initial transfer is partially unwound and the identity of the transferee does not change (e.g., the transferee pays an additional amount for the asset). Price adjustment clauses were found to be against public policy in Procter because, if such clauses were effective, the result of an audit of the gift tax return could never result in a deficiency. Although the same public policy argument applies to formula defined value clauses, they are so commonly used that an argument that they are void is not persuasive.
Moreover, the public policy argument could be addressed by deliberately structuring the formula to produce a small deficiency on audit.

F. In FSA 2001-2011, the IRS attacks a defined value clause that it assumes was executed without "[any] evidence of arm's length negotiations" and which the IRS assumes" the transactional documents were accepted by charity as presented". The IRS concludes the possibility of "any additional transfer to charity under the formula clause was illusory." The IRS also states that

Though *Procter* involved a savings clause as opposed to a formula clause, the principles of *Procter* are applicable to this case. If formula clauses like the one at issue actually function to require payment of any increased value to the charitable donee, these clauses would be similar in effect to savings clauses in that they re-characterize the transaction in a manner that would render any adjustment nontaxable. A valuation increase resulting from an examination would serve only to increase the charitable deduction, but would not otherwise generate any gift tax deficiency.

Moreover, the adjustment would substantiate a claim for an increase in the income tax charitable deduction claimed by the donor. The sole justification for the Commissioner's examination would be to insure that charity received all that it was entitled to under the transfer documents. This would place federal tax administrators in the position of policing charitable transactions, a role more appropriately performed by the states' attorneys general.

G. Commentators, like Stacy Eastland, have argued that the IRS analysis misses several key points, including: (i) the IRS does have a "revenue incentive" to examine a charity's actions in agreeing to the amount of a formula gift, because the charity and the "offending" individual will be subject to IRS sanctions (which potentially increases Treasury revenue), if there is any excess benefit to that individual; (ii) state attorney generals do have a duty to enforce the formula; (iii) the charity has a fiduciary duty under state property law to enforce the formula (and, as noted above, it is clear law that federal gift tax consequences follow state property law); (iv) assuming the charity does engage in arms length negotiations, it is irrelevant whether the formula clause "works," because under gift tax valuation cases and the IRS's own regulations, it is clear arms length negotiations are the best evidence of value; (v) as noted above, the IRS itself mandates formula clauses for charitable split interest trusts and grantor retained annuity trusts, both of which involve the same public policy considerations; (vi) as noted above, the IRS has long accepted formula marital deduction clauses and formula pecuniary disclaimers, which have no more (or less) public policy considerations than formula gifts to charity; and (vii) there is a key distinction between price adjustment clauses such as the one discussed in *Procter* and defined value formula clauses (e.g. marital deduction clauses). One distinction is that the price adjustment clause involves a condition subsequent. In addition, in some defined value formula clauses, the identity of the recipient could change (which is clearly
not in the donor's best interest.)

H. Defined Value Clauses in the Charitable Context.

1. Christiansen v. Commissioner, 130 T.C. No. 1 (2008), concerned a defined-value disclaimer. The decedent left her estate to her daughter. Under the will, 75% of any disclaimed assets would pass to a charitable lead annuity trust (CLAT) and 25% to a private foundation (the "Foundation"). The principal assets of the estate were 99% limited partnership interests in two partnerships. The daughter disclaimed a fractional share of the estate exceeding $6.35 million, based on values "as finally determined" for estate tax purposes.

2. The IRS challenged both the valuation of the partnership interests and the effect of the formula disclaimer on the size of the charitable deduction the estate was entitled to receive. Before trial, the parties reached agreement on the values of the limited partnership interests. The agreement increased the gross estate from $6.51 million to $9.6 million and increased the value of the properties passing to the CLAT and the Foundation. The issue for the court was whether a charitable deduction would apply to the additional value passing to charity.

3. A majority of the Tax Court held that the disclaimer was not qualified for the 75% passing to the CLAT because the daughter was a contingent remainder beneficiary of the CLAT. Judge Swift and Judge Kroupa (the trial judge) dissented from this portion of the opinion. Both believed the disclaimer was qualified. Regarding the 25% passing to the Foundation, the Tax Court unanimously validated the formula disclaimer and allowed a charitable deduction. The court noted that the transfer was the result of a disclaimer governed by Treas. Reg. § 20.2055-2(c), which relates back to the decedent’s death as if it had been part of the will. The court also stated:

The regulations speak of the contingency of "a transfer" of property passing to charity. The transfer of property to the Foundation in this case is not contingent on any event that occurred after Christiansen’s death (other than the execution of the disclaimer)—it remains 25 percent of the total estate in excess of $6,350,000. That the estate and the IRS bickered about the value of the property being transferred doesn’t mean the transfer itself was contingent in the sense of being dependent for its occurrence on a future event. Resolution of a dispute about the fair market value of assets on the day Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future. Our Court is routinely called upon to decide the fair market value of property donated to charity—for gift, income, or estate tax purposes. 130 T.C. No. 1, at 30.
4. The court rejected the IRS's public policy argument, noting that it was "hard pressed to find any fundamental public policy against making gifts to charity—if anything the opposite is true. Public policy encourages gifts to charity, and Congress allows charitable deductions to encourage charitable giving." Id. at 32–33. Rejecting the IRS's Procter analogy, the court noted:

This case is not Procter. The contested phrase would not undo a transfer, but only reallocate the value of the property transferred among Hamilton, the [CLAT], and the Foundation. If the fair market value of the estate assets is increased for tax purposes, then property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn’t in any way upset the finality of our decision in this case. Id. at 33–34

5. The court added that a charity’s directors, as well as executors of an estate, owe fiduciary duties that are enforceable by the IRS and the state’s Attorney General.

6. Although sound arguments exist for a taxpayer to assert that the public policy holding in Procter and its progeny should not be followed in today’s world given the broad approval granted to a variety of formula clauses in IRS pronouncements, practitioners should be cautious when using adjustment clauses that cause property to be returned to the donor (or deemed never transferred) similar to those used in Procter and Ward. Defined-value planning, however, involves a different structure than addressed by the courts in Procter and its progeny because no condition subsequent is present.

7. Practitioners should be aware that the charitable techniques of McCord and Christiansen are different from each other in terms of the effect of a successful IRS challenge to value. A McCord-type of defined-value formula (a transfer of interests of a specific dollar value to noncharity donees with the remainder to charity, not based on values as finally determined for transfer tax purposes) turns on the state law property rights transferred. If, after the transfer, the donees reach an arm’s length agreement regarding the allocation of the interests among themselves under the formula, a successful IRS challenge to the value of the interests transferred does not change that allocation. On the other hand, a Christiansen-type of defined-value formula (a transfer of interests of a specific dollar amount to noncharity donees with the remainder to charity, based on values as finally determined for transfer tax purposes) is affected by a successful IRS challenge to the value of the interest transferred. Under that type of a clause, if the value of the interest transferred is
increased, the size of the interest passing to charity is likewise increased. That increase applies for state law purposes whether or not an additional charitable deduction is ultimately allowed. For a *McCord*-type of defined-value formula, both the IRS and the courts will examine any pre-transfer dealings with the charity. It is important for the taxpayer to be able to demonstrate that the transaction with the charity was at arm’s length and that there was no pre-arranged deal between family members and the charity providing that the charity would receive a specific interest in the entity transferred. As the Fifth Circuit noted in *McCord*:

> Neither the Majority Opinion nor any of the four other opinions filed in the Tax Court found evidence of any agreement—not so much as an implicit, “wink-wink” understanding—between the Taxpayers and any of the donees to the effect that any exempt donee was expected to, or in fact would, accept a percentage interest in MIL with a value less than the full dollar amount that the Taxpayers had given to such a donee two months earlier. *McCord*, 461 F. 3d at 620.

8. In this regard, it is also helpful for the charity to have its own counsel review the transaction and, if the charity deems appropriate, obtain its own valuation analysis.

9. With testamentary defined-value transfers involving charities, it is often difficult to set a formula in the will because the value of the estate is a moving target. Thus, clients may prefer dollar value formula disclaimers like the one used in *Christiansen*. This type of formula allows, but does not require, the children to disclaim assets to a charity selected by the decedent in his or her will. Charitable disclaimer planning like *Christiansen* generally requires all beneficiaries of the estate to act together. If all do not disclaim, the defined-value structure will have a “leak” that leads to estate tax if valuation is successfully challenged by the IRS, because not all of the increase in value passes to charity. Careful consideration should also be given to the drafting of debts, expenses, and tax allocation provisions, because the boilerplate of many wills simply allocates those obligations to the residue of the estate.

10. For clients without the requisite charitable intent, or worried about family members negotiating with the charity over the percentage interests received by each donee in a *McCord*-type transaction, a defined-value transfer using a GRAT might be considered. The structure would consist of a transfer of interests equal to a specific dollar amount to non-GRAT donees, with the remainder passing to a GRAT based on values as finally determined for transfer tax purposes. In the event of a successful valuation challenge by the IRS, the increased value would result in a larger transfer to the GRAT and, as required by Code § 2702, increase the annuity owed.
to the donor. This type of transaction is similar to the consideration adjustment structure used in *King*. The difference is that, in a *King* transaction, the property transferred to each recipient does not shift as it would in the case of a GRAT; rather, the amount the recipient is required to pay is based on the value of the property as finally determined for transfer tax purposes. What might make the GRAT more desirable than the consideration adjustment provision in *King* is that the Regulations under Code § 2702 offer some comfort if faced with a *Procter* argument. In addition, if the GRAT is not a "zeroed-out" GRAT, a successful IRS challenge would result in some additional tax being due, which would make it difficult for the IRS to argue, as it did in *Procter*, that the clause violated public policy.


**XIX. FREEZING - LOANS, INSTALLMENT SALES, ANNUITIES, AND PARTNERSHIP FREEZES.**

A. **Loans.**

1. A loan from a business to a shareholder, employee, or other person is subject to scrutiny under Code § 7872, which provides rules applicable to "below market loans" (BML). Code § 7872 requires the imputation of interest in the case of certain loans where stated interest is less than the applicable federal rate (AFR) appropriate to the loan. Code § 7872 was enacted to block perceived loopholes which the IRS had been only partially successful in closing.

2. The first of these was the gift loan. Persons of means had been making interest-free loans to the objects of their bounty. While the donees often used the loan proceeds to purchase homes or other items, they were free to invest the proceeds and to retain the after-tax income. In view of the fact that there were no specific Code provisions addressing such transactions (since they did not involve the sale or exchange of property), the donors for many years contended that these transactions did not give rise to any gift tax even though the donees received a direct and measurable economic benefit from the interest-free use of the money. Economically, these transactions were indistinguishable from arrangements under which the donor directs the payment of the income from property owned by the donor to designated persons. In this type of situation, the assignment of income doctrine requires that the income from the property be taxed to the property owner, or, where a grantor trust is used, to the grantor. In a series of cases culminating in *Dickman v. Comr.*, the IRS persuaded the courts that interest-free loans of this type resulted in gifts, measured generally by the amount of interest that could have been derived from investing the
loan proceeds at market rates. In these cases, however, the IRS did not raise the question of whether the donor, in addition to the gift tax, should also be subject to tax on the income arising, or deemed to have arisen, from the use of the loan proceeds. In these circumstances, there was no question as to whether the donee was entitled to deduct any deemed interest payments to the lender.

3. Another perceived loophole was presented in cases involving interest-free loans from corporations to their shareholders. In these cases, the IRS focused on the economic benefit enjoyed by the borrower which it sought to characterize as equivalent to a distribution with respect to stock. In these cases, the IRS was unsuccessful primarily because it was unable to counter the argument that if the borrower were to be treated as receiving income in the amount of the interest forgone by the corporate lender, the borrower also must be allowed an equivalent deduction for the interest that would have been payable had such interest been charged. In these cases, the IRS apparently never sought to impose a tax on the corporate lender on the theory that the transaction was the equivalent of a distribution of the interest from funds invested at the corporate level. In one case, the IRS successfully contended that a corporate distribution resulted from the sale of corporate assets to shareholders where the funds to make the purchase were made available to the shareholder by an interest-free term loan. The Tax Court held that the amount of the distribution was equal to the excess of the property's fair market value over the present value of the payments due under the loan terms discounted at market interest rates.

4. Finally, interest-free loans made by an employer to an employee (or made to an independent contractor by a person for whom the contractor performs services) could be used as a means of compensation. In such cases, which seem largely to have escaped concerted IRS scrutiny, the result is generally relatively tax neutral. The payment of compensation in this form, however, avoids the payment of employment taxes. Further, as pointed out in the DEFRA Bluebook, where such a loan is a term loan, the borrower receives the benefit in the year of the loan, but any deemed interest payments would be deductible over the term of the loan in which case there would not be a matching offset of income and deductions.

5. Code § 7872 was enacted to close these perceived loopholes by recharacterizing any interest-free or below market loan of the types discussed above, together with any other such loan which was or could be availed of to avoid tax, as an arm's-length transaction in which the lender made a loan to the borrower in exchange for a note requiring the payment of interest at the applicable federal rate. Specifically, Code § 7872 results in the parties being treated as if:
a. The borrower paid interest to the lender that may be deductible by the borrower and is included in income by the lender; and

b. The lender –

1. Made a gift subject to the gift tax (in the case of a gratuitous transaction),

2. Paid a dividend or made a contribution to capital (in the case of a corporation/shareholder loan),

3. Paid compensation (in the case of a loan to a person providing services), or

4. Made some other payment characterized in accordance with the substance of the transaction.

B. **Installment Sale.**

1. A simple alternative to an outright gift or a private annuity transaction is a sale of the business owner's entire interest in the business in exchange for an installment note.

2. If the business owner's basis in the transferred interest is significantly lower than its fair market value, recognition of capital gain can be deferred over the entire period of the installment note under Code § 453.

3. A major advantage of the installment sale technique is the ability to set a relatively low interest rate on the promissory note payments and avoid the possibility that the transaction will be re-characterized as a bargain sale. In *Frane*, 98 T.C. 554 (1992), the Tax Court held that the Code § 7872 rates will apply to determine whether or not an installment note will be valued at less than face value for the purposes of the application of the gift tax.

4. If the installment sale technique is utilized, care must be taken to coordinate the balance of the transferor's estate plan with the installment note technique. For example, upon the transferor's death, the fair market value of the note will be included in his or her estate. Assuming that the note is left to the obligor under the note, the tax apportionment provisions of the estate plan might provide that the obligor bear the transfer tax liability attributable to the note.

5. If the property transferred has a fair market value significantly in excess of its basis, the untaxed portion of the gain will be taxed to the transferor's estate (and reportable on the fiduciary income tax returns filed for the
estate or trust) if the installment note is forgiven upon the transferor’s death, or transferred to the obligor as a consequence of transferor’s death. _Frane v. Commissioner_, 98 T.C. 341 (1992), reversed in part and affirmed in part, 998 F.2d 567 (8th Cir. 1993). The capital gain so recognized will constitute an item of income in respect of a decedent under Code §§ 453B(f)(1) and 691(a)(2).

6. The transferor may desire to elect out of the installment method at the time the sale is consummated, and recognize all capital gain liability in the year of sale. This will eliminate the future taxation of the unrecognized gain as income in respect of a decedent. Effectively, if the transferor is in the 55% estate tax bracket, the government will be paying 55% of the income tax liability attributable to the gain recognized in the year of sale.

7. If the transferor desires, he may utilize the $10,000 gift tax annual exclusion to forgive a portion of the installment note payments each year (up to $20,000 per year if the transferor is married and the gift splitting election under Code § 2513 is made for all gifts made during the applicable calendar year). However, if the forgiveness of the note payments is part of a prearranged plan, the Service could argue that the transaction constitutes a bargain sale. See, e.g., Rev. Rul. 77-299, 1977-2 C.B. 343. The forgiveness of payments will cause recognition for income tax purposes of the gain element inherent in the forgiven payment.

8. Assuming that the purchaser of the business interest materially participates in the business, and that the business is carried on as a partnership or S corporation, it is likely that the purchaser will be able to deduct the interest paid on the promissory note, and will not be subject to the investment interest limitations of Code § 163(d). See Code § 163(d)(5)(A); Priv. Ltr. Rul 9037027.

   a. All future appreciation in the value of the property sold is removed from the transferor’s estate.
   b. Assuming that the purchaser remains solvent, the transferor is guaranteed a fixed revenue stream for the term of the installment note.
   c. The purchaser of the stock immediately receives a basis in the stock equal to the purchase price, even though the payment of the purchase price will be deferred over the period of the note. If the sale is structure as a sale to a "defective" grantor trust, however, the trust will assume the seller’s basis in the stock.
d. In the current low interest rate environment, the interest rate payable under the note need not exceed the applicable rate under Code § 7872. This results in minimizing the growth of the transferor's estate from his or her receipt of interest payments. In addition, when the transferor dies, the appraised value of the installment note should reflect a significant discount for the low interest rate payable under the note, provided that the note is left to someone other than the obligor.

10. Disadvantages:
   a. The transferor's estate will forego a basis step-up on the transferor's death in the installment note received in exchange for the stock.
   b. The purchaser must continue to make the installment payments, even if the value of the purchased asset declines in the period following the sale.
   c. If the transferor is dependent upon the installment note payments, and the purchaser subsequently is unable to make the payments, or receives a discharge in bankruptcy, the transferor may not have any recourse other than a security interest in the assets sold which may have become worthless.

C. Self-Canceling Installment Note.

1. A self-canceling installment note (SCIN) is defined as a debt obligation that by its terms is extinguished at the death of the seller-creditor, with the remaining note balance cancelled automatically. The primary advantage of a SCIN over a straight installment sale is that if the seller dies prior to the expiration of the installment term, the remaining value of the installments are totally excluded from the seller's estate. Moreover, the SCIN provides an advantage over a private annuity in that the seller does not incur the tax risk of living well beyond the installment term, thereby increasing the seller's gross estate by continued annuity payments.

2. To compensate the seller for the risk of cancellation, the SCIN must contain a "risk premium," which may be reflected either in the purchase price of the assets or the interest rate of the note. Consequently, for the SCIN to be beneficial from an estate planning standpoint, either of the following must occur:
   a. The return on the asset that is sold must exceed the interest rate on the SCIN.
b. The seller must die before his or her life expectancy.

3. SCIN may be classified as either an installment sale or a private annuity for income tax treatment and valuation purposes. If the maximum term of the SCIN exceeds the life expectancy of the seller (as determined under Reg. 1.72-9), the SCIN is classified as a private annuity. If the installment term does not exceed the seller's life expectancy, the SCIN is classified as an installment sale. The differences between these two methods are discussed below. In most situations, the preference is to structure the SCIN so that it is treated as an installment sale.

4. IRS Rulings and case law have attempted to clarify some of the issues with respect to the income tax treatment and valuation of SCINs. Many of the uncertainties have been addressed in the last few years, creating the need to review the usefulness of SCINs in light of recent developments and current interest rates.

5. Estate tax consequences.

a. The primary advantage of a SCIN for estate tax purposes is that the cancelled notes or contract payments are not included in the estate of the seller. Therefore, if the seller suffers a premature death, the SCIN may provide substantial estate tax savings. Also, even if the seller lives for the entire installment period, the sale of the property freezes the value of the asset and removes any appreciation on such property from the estate of the seller.

b. Because current interest rates are relatively low from a historical perspective (even after allowing for an interest rate risk premium), the use of a SCIN with an asset that has the potential for substantial appreciation may provide significant estate tax savings.

c. Moreover, in April 1999 the IRS issued proposed and temporary regulations revising the actuarial tables to reflect longer life expectancies. Because the longer life expectancies reduce the likelihood of a seller dying before the end of the installment term, the risk premium required should be less. An exception to the use of the mortality tables applies in the event of a "terminal illness." A person is defined as terminally ill if the probability of death within one year is at least 50%. On the other hand, if the individual survives for at least 18 months, he or she is presumed not to have been terminally ill unless the contrary is established by clear and convincing evidence. Therefore, a SCIN is ideal for someone in poor health—but not terminally ill—who is not likely to live out the life expectancy indicated in IRS tables.
   
a. GCM 39503 states that the sale for a SCIN is not subject to gift tax if the sales price and length of payment are reasonable when compared with the value of the property transferred. The SCIN must contain a risk premium reflected as either an increase in the sales price or a higher interest rate in order to account for the possibility that the seller will die prior to the end of the installment term. If the fair market value of the property exceeds the SCIN's value, the seller has made a gift of the excess.

b. When valuing a SCIN classified as a private annuity, the IRS has taken the position that the transfer tax mortality tables and discount rates determine the value of the SCIN and whether a gift has been made. This valuation method is relatively simple as the IRS provides actuarial tables for the shorter of one life or a term of years.

c. On the other hand, if the SCIN is classified as an installment sale, GCM 39503 states that the facts-and-circumstances approach may be used. This implies that some flexibility may be allowed in valuing the SCIN for gift tax purposes. From a transfer tax standpoint, this flexibility may allow the installment payments to be less than under the transfer tax tables. The downside to this approach, however, is the subjectiveness of the valuation, and the corresponding possibility that the IRS may object to such valuation.

7. Income Tax Treatment.
   
a. Transferor's treatment of gain. Assuming the SCIN is treated as an installment sale, gain recognized by the transferor who receives the SCIN is reported over the period during which payments are received. Each payment is divided into a return of basis, capital gain (assuming capital asset), and interest income. The amount of each item is determined by assuming that the maximum price will be received and by allocating these amounts proportionally to each installment payment. This method of reporting effectively allows the seller to defer capital gain over the period payments are received. Any gain remaining at the seller's death, however, is recognized by the decedent's estate.

b. Capital gain on cancellation. Assuming the SCIN is treated as an installment note, recent case law and IRS rulings clearly indicate that based on Code § 453B(f), capital gain is recognized at death when a self-cancellation provision becomes operative. Historically,
there was a question as to whether the gain is recognized on the
decedent's final return or by the decedent's estate.

c. The Eighth Circuit, in *Estate of Frane*, held that the capital gain
should be treated as income in respect of a decedent (IRD) under
Code § 691(a)(5)(A)(iii), which provides that "any cancellation of
such an obligation occurring at the death of a decedent shall be
treated as a transfer by the estate of the decedent...." Therefore, the
gain is recognized on the estate income tax return and the tax
liability resulting from the cancellation of the SCIN cannot be
deducted as a debt of the estate on the estate tax return. In addition,
losses from the decedent not used during his or her lifetime cannot
be used to offset the gains realized by the decedent's estate on the
cancellation of the SCIN.

d. Basis of property. The law is not entirely clear with respect to the
buyer's basis in the property, as the installment sale rules do not
address this issue with respect to a SCIN. GCM 39503, however,
concludes that the buyer's basis in property acquired in an
installment sale is the full face value of the note. This appears to be
the correct result as the decedent must recognize capital gain on
the SCIN. The courts, however, have not specifically addressed
this issue.

e. Based on GCM 39503, installment treatment is advantageous to
private annuity treatment for purposes of determining the buyer's
basis. If the SCIN is treated as an annuity, the buyer's basis for
determining gain during the seller's lifetime is only the present
value (using IRS tables) of the right to receive payments. Thus, the
basis should initially equal the purchase price of the asset. The
buyer's basis increases only when the aggregate annuity payments
exceed the projected present value of the payments. Accordingly,
on the cancellation of a SCIN treated as an annuity, the buyer's
basis is fixed. On the other hand, if the SCIN is treated as an
installment sale, the buyer's basis is the face amount of the note.

f. Buyer's interest deduction. GCM 39503 also provides that, subject
to other limitations, the interest paid by the buyer is fully
deductible. These other limitations, however, apply to the type of
property used in a SCIN transaction. For instance, if a SCIN is
used to purchase investment property, the interest may be deducted
only to the extent of the buyer's net investment income from all
sources, unless a passive activity is involved. Investment income is
defined as income from dividends, annuities, or royalties not
derived in the ordinary course of a trade or business. Any
investment interest not deductible may be carried forward to the following year.

g. Passive Activity. If the investment is also a passive activity, the interest deduction is generally limited to investment income of the particular investment. The passive loss rules in Code § 469 provide that the losses and credits from a passive activity cannot be used to offset income from nonpassive activities. Passive activities are defined as trades or businesses in which the taxpayer does not materially participate, including all rental activities. In contrast, if the SCIN is treated as an annuity, the purchaser gets no interest deduction.

h. Security or guarantees. In addition to the differences between SCINs and annuities discussed above, an advantage to a SCIN is that the transferor may take certain security or guarantees without jeopardizing the installment sale treatment. If a transferor receives security for a private annuity, the entire gain is taxable at the time of the transfer.

i. Sale of marketable securities. The sale of marketable securities is not eligible for installment reporting for income tax purposes. The sale of a partnership interest that owns marketable securities for a SCIN, however, should qualify for installment treatment if the selling partner could not have sold or caused the sale of the publicly traded securities.

D. Private Annuities.

1. A private annuity is a transfer of property from an annuitant (the transferor) who is not in the business of issuing annuities, to an obligor (the transferee) in exchange for the obligor’s promise to make periodic payments of fixed amounts for the remainder of the annuitant’s life or other specified period. Private annuities also can be structured to have a joint and survivor provision.

2. The annuitant purchases the annuity by transferring money or other property to the obligor. The obligor may be an individual, corporation, trust, foundation, or other entity.

3. The most advantageous and common use of private annuities is for intrafamily transfers with the annuitant being the parent and the child being the obligor. Other common private annuity situations involve the redemption of stock by a closely held corporation in exchange for the annuity. Private annuities may, however, also be established between unrelated parties.
4. The tax consequences of private annuities are described in Rev. Rul. 69-74. The gain realized on a private annuity is the excess of the present value of the annuity over the annuitant's basis. The annuitant's income tax treatment is governed by Code § 72. Part of each annuity payment is a tax-free return of capital, while the remainder is subject to taxation.

5. Capital asset property. If the property used to fund the annuity is a capital asset, the gain (e.g., excess present value of annuity over basis in asset) is capital gain. Any excess FMV over the present value of the annuity received is a taxable gift to the obligor. Gain is reported over the term of the annuity or the annuitant's life expectancy. Tables containing life expectancy factors are in Treas. Reg. § 1.72-9.

6. All annuity transfers after 1986 may not exclude more than the annuitant's investment in the contract as tax-free return of income. Once the annuitant fully recovers his or her investment in the contract, the balance of the payments received are fully taxable as ordinary income. Before 1987, there was no limitation on the exclusion ratio, i.e., if the annuitant outlived his or her actuarial life expectancy, a portion of the payments would still be tax-free. For annuity transfers taking place after 7/1/86, if the annuitant dies before recovering his or her full investment in the contract, Code § 72(b)(3) provides that the unrecovered amount can be taken as a deduction on the decedent's final return. There was no such rule for transfers before 7/2/86.

7. Depreciable property. If depreciable personal property used in a trade or business is transferred instead of capital gain property, the depreciation must be recaptured under Code § 1245. If real property is transferred, the recapture must be reported under Code § 1250. These provisions require income recognition of the depreciation recapture in the year the property is first transferred in exchange for the annuity. The obligor's basis for depreciating the property received in exchange for the annuity can change as annuity payments are made. Prior to the annuitant's death, the property's unadjusted basis starts at the value of the prospective payments. Once payments equal the value of the annuity on the date of the transaction, additional payments are added to basis. After the annuitant's death, however, the obligor's unadjusted basis is the total of annuity payments actually made.

8. Unfortunately for the obligor, the actual price paid for the annuity property cannot be determined until the annuitant's death. Thus, payments made by the obligor during the annuitant's life are treated as capital expenditures for tax purposes. The obligor cannot deduct any part of the payment as interest, even though the annuitant must pay tax on the interest part of each payment. The obligor can, however, increase his or her basis in the
transferred property as payments are made. If the obligor disposes of the property after the annuitant's death, the obligor's unadjusted basis in the property is the total payments made. If the property used to fund the annuity is sold before the annuitant's death, the obligor has a "split" basis for determining gain or loss. The unadjusted basis for determining gain is the total annuity payments made up to the time of disposition and the present value of the prospective payments still to be made (as determined under Code § 7520). The unadjusted basis for determining loss is the total payments made up to the time of sale. If the sale price is less than the adjusted basis for gain and more than the adjusted basis for loss, neither the gain nor the loss is recognized.

9. Gift taxes. One of the more common uses of private annuities for family transfers is to include a gift element in the annuity contract. This allows parents, grandparents, or other relatives to transfer property to children, make gifts, and still ensure their own financial well being. When property is transferred for less than its full consideration, the Service treats the portion of the transfer that is less than the property's FMV as a gift. If a gift is not intended, the FMV of the transferred property must equal the present value of the annuity. Thus, the property should be appraised if it is not easily valued on public markets. Further, consulting with an actuary can help avoid any surprise partial gifts and tax penalties. When part of a private annuity transaction is treated as a gift, the donor-annuitant's basis (i.e., investment in the contract) cannot exceed the present value of the prospective annuity payments that will be made. If depreciable and nondepreciable property are used, the basis for the gift portion is allocated between the two properties proportionally. Suppose the obligor is the one making the gift. The obligor's basis is limited to the value of the property received for purposes of determining both depreciation and gain or loss (i.e., the obligor gets a zero basis for the gift portion of the property).

10. Estate taxes. To avoid inclusion of the transferred property in the annuitant's gross estate, an annuitant must not retain a security interest in the transferred property. If an annuitant retains a security interest that allows repossession of the property on the obligor's default, the annuitant may have this property included in his or her estate under Code § 2036, as a transfer with a retained life estate.

11. Advantages. For annuitants who die prematurely, private annuities are a low transfer tax way to avoid having property taxed in the estate under Code § 2036. Aside from this (and for those who expect to live out their life expectancies), the greatest benefit of a private annuity is to a transferor (the annuitant) who wants to keep ownership of certain property within the family, while having the security of a fixed income for life. Further, the annuitant can remove any future appreciation on the transferred property from his or her gross estate. Property transferred within three years of the
annuitant's death should not be included in the annuitant's gross estate, provided a life estate or security interest was not retained that would cause inclusion under Code §§ 2036, 2037, 2038 or 2042.

12. Disadvantages. The most precarious aspect of entering into a private annuity agreement is the annuitant's life expectancy. The uncertainty of death may cause difficulties. If the annuitant dies prior to his or her actuarial life expectancy, the obligor's basis may be lower than it would have been had the property been inherited. In the alternative, if the annuitant outlives his or her actuarial life expectancy, the annuity payments may exceed the value of the contract or the estate tax value assigned to the assets had it been retained by the estate. An annuitant who outlives his or her actuarial life expectancy will have to pay income tax on the entire realized gain. Further, if the annuitant does not spend the payments, they will increase his or her estate, perhaps by more than the underlying property would be worth if the annuitant outlives his or her life expectancy. An additional risk to the annuitant is that the obligor may predecease him or her—jeopardizing the receipt of future payments. Because annuity payments are usually made from after-tax dollars, with part of the payments being included in the annuitant's income as interest, a private annuity may increase the overall tax burden to the parties involved. Even though the annuitant receives interest income, the obligor cannot take the interest expense deduction for any portion of the annuity payment. If the property used to fund the annuity is of a very high economic value, it may place a financial burden on the obligor to make such high annuity payments.

13. On October 18, 2006, the Department of Treasury issued Prop. Regs. § 1.72-6 and Prop. Regs. § 1.1001-1 that eliminate the income tax advantages of selling appreciated property in exchange for a private annuity. The proposed regulations require the seller's gain to be recognized in the year the transaction is effected rather than as payments are received. The proposed regulations generally would apply for transactions entered into after Oct. 18, 2006, but certain transactions effected before Apr. 19, 2007 would continue to be subject to the current rules. Under the proposed regulations, the following would occur when an annuity contract is received in exchange for property (other than money):

a. The amount realized attributable to the annuity contract would be the FMV (as determined under the valuation tables issued under Section 7520) of the annuity contract at the time of the exchange;

b. The entire amount of the gain or loss, if any, would be recognized at the time of the exchange, regardless of the taxpayer's method of accounting; and
c. For purposes of determining the initial investment in the annuity contract under Section 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract would equal the amount realized attributable to the annuity contract (the FMV of the annuity contract).

For an exchange of property for an annuity contract that is in part a sale and in part a gift, the Proposed Regulations apply the same rules that apply to any other such exchange under Section 1001. Prop. Regs. § 1.1001-1(j)(1). The Proposed Regulations provide that, for purposes of determining the investment in the annuity contract under Section 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract would be the portion of the amount realized on the exchange that is attributable to the annuity contract (which is the FMV of the annuity contract at the time of the exchange). (Reg. § 1.72-6(e)(1))

The annuitant's investment in the contract would be reduced in subsequent years under Section 72(c)(1)(B) for amounts already received under the contract subsequent to the exchange and excluded from gross income when received as a return of the annuitant's investment in the contract. The Proposed Regulations do not distinguish between secured and unsecured annuity contracts, or between annuity contracts issued by an insurance company and those issued by a taxpayer that is not an insurance company. Instead, they provide a single set of rules that leave the transferor and transferee in the same position before tax as if the transferor had sold the property for cash and used the proceeds to purchase an annuity contract. The Proposed Regulations apply for exchanges of property for an annuity contract after October 18, 2006. Thus, they wouldn't apply to amounts received after October 18, 2006, under annuity contracts that were received in exchange for property before that date. For a certain transactions, the Proposed Regulations apply for annuity contracts received in exchange for property after Apr. 18, 2007. The delayed effective date would apply for transactions in which (i) the issuer of the annuity contract is an individual; (ii) the obligations under the annuity contract are not secured, either directly or indirectly; and (iii) the property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange.

E. Partnership Freezes

1. Section 2701 was enacted in 1990 as a part of Chapter 14 and addresses the technique of partnership freezes between family members. On the most basic level, a partnership freeze (prior to 1990) was a technique wherein two classes of partnership interests would be issued; one of which carried a non-cumulative preferred return on what was most often the partner’s capital account (but had no rights to participate in the growth of the entity) and the other, a non-preferred interest, carried the remaining value of the entity, taking into account the entity’s
requirement to pay the preferred return. Prior to 1990, when these interests were valued, the majority of the value was found to be in the preferred interest and the non-preferred interest had no (or little) value. As a result, the non-preferred interest could be transferred at little or no gift tax cost, and the future appreciation in the entity would thereafter be in the donee’s hands, while the donor continued to receive a stream of income from the entity, through its payment of the preferred return. Upon the death of the donor, the only asset includible in his or her estate was the value of the preferred return, which was discounted in light of its non-cumulative nature. All of the appreciation in the entity would therefore escape inclusion in the donor’s estate because it was in the hands of the donee in the form of the non-preferred interest.

2. Section 2701 provides that if the preferred interest does not meet certain requirements set forth in the Section, then such interest will be valued at zero. Thereafter, if any transfer is made of any non-preferred interest, the value deemed to have been transferred shall be based on the “subtraction method” of valuation, calculated as follows:

a. The value of all property contributed to the partnership (or the value of all interests in the partnership) is determined (as though it were held by one individual).

b. The value of the preferred interest is subtracted from the value determined above:

   (1) If the preferred interest does not meet the requirements of Section 2701, the value is deemed to be zero.

   (2) If the preferred interest meets the requirements of Section 2701, the value is determined based on normal valuation methodology, with the exception that any value attributable to most liquidation, put, call or conversion rights (other than rights that must be exercised at a specific time and at a specific amount) attached to the preferred interest, are valued at zero.

c. The remaining value (after the subtraction) is allocated proportionately among the non-preferred interests (including the non-preferred interests held by holders of preferred interests).

d. In a transfer subject to Section 2701, the value of all non-preferred interests, together, must equal at least 10% of the value of all partnership interests, plus the value of any, indebtedness of such entity to the family. Accordingly, notwithstanding the valuation of preferred interests that meet the requirements of Section 2701, if such interests make up more than 90% of the value of the entire entity, the excess of such value over the 90% amount must be
allocated proportionately to the non-preferred “junior” entity interests.

e. If the value allocated to each non-preferred interest is greater than the amount contributed (or the consideration paid) by the owner of the non-preferred interest, a gift has been made.

3. Accordingly, to avoid the gift that would result from the value of the preferred interest to be deemed to have been zero, the preferred interest should either meet the requirements of Section 2701 or the transaction must fit into one of the Section’s exceptions, which are as follows:

a. If market quotations for the preferred interest is readily ascertainable, Section 2701 does not apply.

b. If the transferor transfers interests (i) in the same class or (ii) is proportionately the same as the interests retained by the transferor, Section 2701 does not apply.

c. Section 2701 only applies when (i) there is a transfer, to or for the benefit of a member of the transferor’s family who is in the same or lower generation as the transferor, of an equity (non-preferred) interest in the entity, (ii) after the transfer, the transferor or a family member who is in the same or higher generation as the transferor holds retains a “distribution right” (the payment of which is in the discretion of the entity), and (iii) the entity is controlled by the family (pursuant to the application of certain attribution rules set forth in the Section). For this purpose, “control” means either holding 50% of the capital or profits of the entity or holding the general partner or the manager interest in the entity.

d. Qualified Payments

(1) If the distribution right is deemed to be a “qualified payment” then it will be valued at its fair market value, rather than zero, for purposes of these rules. A qualified payment is one that is paid on a periodic basis that is cumulative and determined at a fixed rate.

(2) If the distribution right is deemed not to be a “qualified payment”, the transferor or family member holding the right may elect to treat the right as a qualified payment and the election is irrevocable.

(3) Once a payment is deemed (or elected) to be a qualified payment, there is an additional consequence to such characterization. If the payments are in arrears by four
years or more, then the payments shall be deemed to have been made when due and such payments shall be deemed to have been reinvested as of such date at the discount rate used in determining the value of interest. Such deemed amount will be a deemed transfer subject to estate or gift taxes, either when the transferor makes a gift (or sells) his or her interest in the entity or at his or her death.

e. If the distribution right is a right to receive a guaranteed payment (pursuant to Section 707(c)) of a fixed amount, then such rights are not subject to the rules of Section 2701.

4. See Private Letter Ruling 200114004 for a partnership freeze using a FLLC that was approved by the Service.

XX. FREEZING - GRATS, SALES TO DEFECTIVE GRANTOR TRUSTS, AND QPRTS.

A. Grantor Retained Annuity Trust.

1. A Grantor Retained Annuity Trust or "GRAT" is an irrevocable trust into which the client makes a gift of property and retains an annuity payable for a term of years. If the client survives the term, any property remaining in the trust passes without any additional gift tax to the remaindermen, or to trusts for their benefit.

2. For gift tax purposes, the value of the gift upon creation of a GRAT is determined by subtracting the value of the retained interest from the value of the property gifted to the GRAT. The retained interest is valued using the "Applicable Federal Rate" ("AFR") promulgated by the Treasury pursuant to Code § 7520 for the month in which the gift is made. If the client has enough remaining applicable exclusion, no gift tax will be due. Generally, if the assets transferred to the GRAT appreciate or produce income at a rate higher than the AFR, the transaction will successfully leverage the gift tax exemption.

3. For purposes of valuing a gift to a GRAT, Code § 2702 provides that if a person transfers an interest in trust to or for the benefit of a member of his or her family and the transferor or an "applicable family member" retains an interest in the trust, then for purposes of determining the value of the interest transferred, any retained interests in the trust that are not "qualified interests" are valued at zero. An "applicable family member" includes the transferor's spouse, an ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor. Both the annuity for a fixed term of years retained by the client and the remainder transferred to the remaindermen are qualified interests. However, the reversion retained by the client is not a qualified interest, and therefore its value is treated as zero. Because the value of the gift upon creation of a
GRAT is determined by subtracting the value of the qualified interests retained by the client, the value of the reversion is effectively reflected in the remainder value transferred to the remaindermen. In effect, the value of the reversion is subject to gift tax as if it had been transferred to the remaindermen, although it was actually retained by the client. Thus, the gift to the remaindermen is the present value of the amount actuarially expected to remain in the GRAT at the end of the term, plus the value of the reversion.

4. Notwithstanding the benefits of the GRAT technique, there are two negative features. First, if the client dies prior to the end of the GRAT term, some or all of the trust assets are included in the client’s estate. The client typically retains a reversionary interest in the GRAT so that the property will pass as part of his or her estate if he or she does not survive the GRAT term. Second, the client cannot allocate generation-skipping transfer ("GST") tax exemption to the trust until the end of the GRAT term, thus precluding use of the GRAT to leverage the GST tax exemption.

5. The Walton case, Walton v. Comm’r., 115 T.C. No. 41 (2000), held that Ex. 5 of the Treasury Regulations is an invalid interpretation of Code § 2702. This case opens the door to creating GRATs with unlimited amounts of value without a gift tax.

6. When considering the transfer of a closely held business interest to a GRAT, consider the collateral valuation issues associated with contribution and distribution of those business interests. For example, client contributes 100% of the stock of a closely held business, valued at $10 million, to a 3 year Walton style GRAT in March 2008 (3.6% Code § 7520 rate). The GRAT, by its terms must distribute 35.76154% of the initial value of the assets contributed to the GRAT. Here is a situation (somewhat analogous to the Ahmanson Foundation and Chenoweth line of cases), where the taxpayer can potentially get whipsawed on the valuation. A contribution of 100% of the stock of company to the GRAT will not generate a discount for lack of control, but an in-kind distribution of a 35.76154% interest in the same shares will certainly generate such a discount. The result being that more shares need to be distributed out of the GRAT, thereby negating its efficacy.

7. Also, when considering a GRAT funded with an interest in a pass-through entity, such as an S corporation or an LLC, consider providing for quarterly GRAT payments, which will allow the grantor to receive distributions from the GRAT that parallel the grantor’s estimated tax payment obligations.

B. Sale to "Defective" Grantor Trust.
1. The sale to a grantor trust, also commonly referred to as a "defective" grantor trust, has become one of the primary leveraging techniques in the estate planning lawyer's arsenal. A defective grantor trust is a trust that Subpart E of Subchapter J of the Code treats as being owned by the grantor but that is not included in the grantor's gross estate. It is also possible to draft and fund a trust so that the beneficiary is the owner of the trust for income tax purposes under Code § 678, but this article does not discuss the use of that technique. Because the grantor is the owner of the trust for income tax purposes, he or she must report all trust income, deductions and credits on his or her personal income tax return. Code § 671-677.

2. A defective grantor trust has three primary benefits.

a. First, the grantor's payment of income taxes on income earned by the trust is the functional equivalent of a tax-free gift to the trust by the grantor.

b. Second, because the trust pays no income taxes while the grantor is living, its assets accumulate income tax-free. For example, assuming a 40% income tax rate, a defective grantor trust that earns income at a rate of 10% per year would have the entire amount of this income remaining in the defective grantor trust. On the other hand, if the trust were not a defective grantor trust, it would have only 6% of the earnings remaining in the trust after taxes.

c. Finally, because the Code treats the grantor as the owner of the trust for income tax purposes, the IRS disregards transactions between the grantor and the trust for income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184.

3. Before the client sells the discounted assets to the defective trust, it is important that he or she give assets to the trust that have a fair market value of at least 10% of the value of the assets that the client plans to sell to the trust. The purpose for independently funding at least 10% is to decrease the likelihood that Code § 2036(a)(1) will apply to the sales transaction and cause those assets to be returned to the client's taxable estate. If the trust owns little or no assets independent of the sales transaction, there is a greater danger that the IRS could recast the transaction as a disguised transfer with a retained interest.

4. The client should file a gift tax return allocating GST exemption to the trust so that it is wholly exempt from generation-skipping taxes. If the gift is less than the client's applicable exclusion amount under Code § 2505, no
gift tax will be due. After the gift, the client enters into a sales agreement with the trustee of the trust whereby the trustee agrees to purchase limited partnership interests or other assets subject to a valuation discount, such as minority interests in a business. The client conveys those assets to the trust in exchange for a promissory note with a face value equal to the fair market value of the assets. If the purchase price equals the fair market value of the purchased assets, there will be no taxable gift or transfer subject to the GST tax. Thus, no additional gift or GST exemption must be allocated to the trust.

5. The parties will structure the promissory note to pay the client interest for a term of years with a balloon payment of principal at the end of the term, using the Code § 1274 interest rate for the month of the sale so that there is no imputed gift under Code § 7872. The payments from the trust to the client are usually very low in comparison to the income earned by the asset being sold to the trust. The Code § 1274 rate is typically low, and that low rate applies to the discounted value of the asset sold rather than against the pro rata value.

6. In Revenue Ruling 2004-64, the Service discusses the estate tax effect of a tax reimbursement clause contained in a defective grantor trust — i.e., a trust that is treated as owned by a grantor for income tax purposes, but whose assets are excluded from the grantor’s estate for estate tax purposes.

a. Situation 1- No Right to Income Tax Reimbursement. Payment of income tax by grantor will not be a gift to trust or trust beneficiaries.


This ruling confirms a position which many taxpayers and practitioners believed to be correct. This ruling is the first formal pronouncement by the IRS which confirms this view.

7. In Revenue Ruling 2007-13, the Service addressed the transfer for value issues when a life insurance policy is transferred to a defective grantor trust. This Ruling addresses the question of whether the transfer of a life insurance contract on the grantor’s life to a grantor trust is a transfer for a valuable consideration within the meaning of Code § 101(a)(2) of the
Internal Revenue Code, and if so, is a transfer to the insured within the meaning of Code § 101(a)(2)(B)?

a. The facts of the Ruling are fairly straightforward. In Situation 1, Trust 1 and Trust 2 are grantor trusts, both of which are treated as wholly owned by the Grantor under subpart E of Part I of subchapter J of the Internal Revenue Code. Trust 2 owns a life insurance contract upon the life of the Grantor. Trust 2 transfers the life insurance contract to Trust 1 in exchange for cash. In Situation 2, the facts are the same as in Situation 1, except that Trust 2 is not a grantor trust.

b. Code § 101(a)(1) provides that, except as otherwise provided in §§ 101(a)(2), 101(d), and 101(f), gross income does not include amounts received under a life insurance contract if such amounts are received by reason of the death of the insured. Code § 101(a)(2) provides, generally, that if a life insurance contract, or any interest therein, is transferred for a valuable consideration, the exclusion from gross income provided by § 101(a)(1) shall not exceed an amount equal to the sum of the actual value of the consideration and the premiums and other amounts subsequently paid by the transferee. The term “transfer for a valuable consideration” is defined for purposes of § 101(a)(2) in § 1.101-1(b)(4) of the Income Tax Regulations as any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy. Code § 101(a)(2)(B) provides that § 101(a)(2) does not apply to a transfer of a life insurance contract or any interest therein to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

c. In Rev. Rul. 85-13, 1985-1 C.B. 184, a grantor acquired the corpus of a trust in exchange for the grantor’s unsecured promissory note. The ruling concludes that the grantor is considered to have borrowed the corpus of the trust and, as a result, is treated as the owner of the trust under § 675(3). Because the grantor is treated as the owner of the trust, the grantor is deemed the owner of the trust assets for federal income tax purposes. In addition, because the grantor is therefore considered to own the purported consideration both before and after the transaction, the exchange of a promissory note for the trust assets is not recognized as a sale for federal income tax purposes.

d. The Ruling concludes that, in Situation 1, because the Grantor is treated as the owner of both Trust 1 and Trust 2 for federal income tax purposes, the Grantor is treated as the owner of all the assets of
both trusts, including both the life insurance contract and the cash received for it, both before and after the exchange. Accordingly, in Situation 1 there has been no transfer of the contract within the meaning of Code § 101(a)(2).

e. In Situation 2, because the Grantor is treated as the owner of all the assets of Trust 1 but not of Trust 2 for federal income tax purposes, the Grantor is treated as the owner of the cash (but not the life insurance contract) before the exchange, and as the owner of the life insurance contract (but not the cash) after the exchange. Accordingly, in Situation 2 there has been a transfer of the life insurance contract for a valuable consideration within the meaning of § 101(a)(2). Nevertheless, the transfer for value limitations of § 101(a)(2) do not apply, because the transfer to Trust 1 is treated as a transfer to the Grantor, the insured, within the meaning of § 101(a)(2)(B).

f. This ruling is consistent with Private Letter Rulings issued by the IRS, including, Priv. Ltr. Ruls. 200636086 (September 8, 2006); 200606027 (February 10, 2006); 200518061 (May 6, 2005); 200514001 and 200514002 (April 8, 2005); 200247006 (November 22, 2002), and 200228019 (April 10, 2002).

g. The benefit of this planning is two-fold. First, as the Ruling clearly states, the transfer of a policy to a grantor trust will qualify for the exception to the transfer for value rules. The second, more interesting planning implication, is that the policy can be sold to a grantor trust for full and adequate consideration and escape the three-year rule of Code § 2035.

h. Consider the following situations where this type of planning may be useful:

1. Grantor owns a policy on her life, whether issued yesterday or 10 years ago, and sells it to her grantor trust to avoid the three-year rule. How so? The three-year rule does not apply to transfers for adequate and full consideration. Code § 2035(d). No transfer-for-value problem because the sale is disregarded.

2. Grantor Trust 1 owns a policy on grantor’s life, but planning is better served if the policy is in Grantor Trust 2. Sell the policy to Trust 2, either for cash or a promissory note. If both trusts are grantor trusts, there are no income tax consequences whatsoever. If only Trust 2 is a grantor trust, there is no transfer-for-value violation because the transfer-to-insured exception is met (although there may be taxable gain when Trust 1 is not a grantor trust).
3. Grantor-insured’s employer or qualified plan owns a policy on grantor’s life. In both cases, taxable income to the grantor-employee and the three-year rule can be avoided with a sale of the policy to the grantor trust (adequate and full consideration exception). In addition, there is no transfer-for-value problem because it is a transfer to the insured.

4. A and B own policies on the other’s life for cross purchase buy-sell purposes. When the arrangement is terminated, A can sell the policy on B’s life to B’s grantor trust, and vice versa. No three-year rule (adequate and full consideration exception) and no transfer-for-value (transfer-to-insured exception) although there may be taxable gain on the sale.

8. In Notice 2007-73, the IRS described two “transactions of interest” involving a grantor trust where the grantor trust status was “toggled” off and then “toggled” on. The IRS and Treasury Department believe this transaction has the potential for tax avoidance or evasion, but lack sufficient information to determine whether the transaction should be identified specifically as a tax avoidance transaction. The notice identifies this transaction, and substantially similar transactions, as transactions of interest for purposes of Treas. Reg. § 1.6011-4(b)(6) and Code §§ 6111 and 6112. The notice also alerts persons involved with these transactions to certain responsibilities that may arise from their involvement with these transactions. It does not appear that turning off the grantor trust status of a trust is affected.

9. A power that is often used to cause a trust to be a grantor trust is a nonfiduciary power in the grantor to substitute assets of equivalent value with the trust under Code § 675(4)(c). In Revenue Ruling 2008-22, 2008-16 I.R.B. (April 21, 2008), the IRS provided guidance under section 2036 regarding the tax consequences of a retained power to substitute assets in a trust. This ruling is immensely important to sophisticated estate planning, and it deserves close scrutiny by estate planning practitioners.

a. Under the facts of the Ruling, a U.S. citizen funded an irrevocable inter vivos trust for the benefit of his descendants and named another person as the trustee. The trust instrument specifically prohibited the grantor from serving as trustee and granted the grantor the power, exercisable at any time, to acquire any property held by the trust - by substituting other property of equivalent value. The substitution power was exercisable by the grantor in a non-fiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. The trust did, however, require that in order to exercise the substitution power, the grantor must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value. Local
law, furthermore, imposed upon the trustee a fiduciary obligation to ensure that the properties being exchanged are of equivalent value. Also, local law imposed upon the trustee of a trust that has two or more beneficiaries, a duty to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. Without restriction in the trust instrument, the trustee has the discretionary power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition, and manage the trust property in accordance with the standards provided by law. The grantor died after the trust was created and funded, and the IRS raised the question of whether the trust assets should be includible in the grantor’s gross estate under Section 2036(a) or 2038(a), on account of the reserved nonfiduciary power to substitute trust assets.

b. The IRS ruled that the substitution power will not, by itself, cause the value of the trust corpus to be includible in the deceased grantor’s gross estate, as long as the trustee has a fiduciary obligation (under local law) to ensure the grantor’s compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. The IRS reviewed the operation of Sections 2036(a) and 2038(a) on property transferred by a decedent during his or her lifetime. Section 2036(a) includes in the value of a decedent’s gross estate the value of all property transferred by the decedent at any time (other than by a bona fide sale for full and adequate consideration in money or money’s worth), whether by trust or otherwise, if the decedent has retained for life or for any period not ascertainable without reference to the decedent’s death or a period that does not in fact end before the decedent’s death, if:

(1) the decedent retained the possession or enjoyment of the property or the income from the property; or

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

c. Section 2038(a)(1) includes in the value of a decedent’s gross estate the value of all property transferred by the decedent at any time (other than by a bona fide sale for full and adequate consideration in money or money’s worth), whether by trust or otherwise, where the enjoyment of the transferred property was, on
the date of the decedent's death, subject to any power held by the decedent (in whatever capacity, alone or in conjunction with any other person) to alter, amend, revoke, or terminate the transfer, or where any such power is relinquished during the three-year period ending on the date of the decedent's death.

d. The IRS also reviewed the Tax Court's decision in Estate of Jordahl v. Comm'r, 65 T.C. 92 (1975), acq. in result, 1977-2 C.B. 1, in which the Tax Court held that, because the decedent was bound by fiduciary standards and was accountable in equity to the succeeding income beneficiary and remainder beneficiaries, the decedent could not exercise the reserved substitution power to deplete the trust or to shift trust benefits among the beneficiaries. The court held that the substitution power was not, therefore, a power to alter, amend, or revoke the trust under Section 2038, even though the decedent reserved the power to substitute other securities or property for those held in trust (provided the substituted property was equal in value to the property replaced). In Jordahl the IRS argued that the trust assets were includible in the decedent's gross estate under Section 2038, because the decedent's power to substitute assets of equal value could be exercised to alter the beneficial interests in the trust. The court disagreed, noting that the decedent's fiduciary duty to the beneficiaries stood between him and the ability to treat the property as his own and thus fell outside the scope of Section 2038.

e. Under the facts in Jordahl, the trust instrument in Revenue Ruling 2008-22 stated that the grantor's power to substitute assets of equivalent value was held in a non-fiduciary capacity. Thus, the grantor was not subject to the rigorous standards attendant to a power held in a fiduciary capacity. The trust instrument also expressly prohibited the grantor from serving as trustee. The IRS, however, focused upon the duties imposed upon the actual trustee of the trust. Generally, a trustee has a fiduciary duty to the trust and its beneficiaries and is held to a high standard of conduct with respect to the administration of the trust. A trustee has a duty to the beneficiaries of the trust to administer the trust solely in their interest, which, in turn, requires the trustee to act fairly, justly, honestly, in the utmost good faith, and with sound judgment and prudence. The trustee also has a duty of impartiality that requires the trustee to take into account the interests of all the beneficiaries for whom the trustee is acting. Thus, for example, a sale, encumbrance, or other transaction involving the investment or management of trust property entered into by the trustee for the trustee's own personal account or which is otherwise affected by a
conflict between the trustee's fiduciary and personal interests is usually voidable by any affected beneficiary. The trustee furthermore must act impartially as to multiple beneficiaries, in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests.

f. In situations like that of Revenue Ruling 2008-22, where the grantor of a trust holds a non-fiduciary power to replace trust assets with assets of equivalent value, the grantor is not subject to a fiduciary duty, but the trustee is and the trustee has a duty to ensure that the value of the assets being replaced is equivalent to the value of the assets being substituted. A trustee who knows or has reason to believe that the exercise of the substitution power does not satisfy the terms of the trust instrument because the assets being substituted have a lesser value than the trust assets being reacquired, has a fiduciary duty to prevent the exercise of the power. The IRS was thus assured in the facts of the ruling that the trustee's fiduciary duty would preclude the grantor from exercising the power to substitute assets in a manner that would reduce the value of the trust corpus or increase the grantor's net worth, or cause any shifting of benefits between or among the beneficiaries occur. Therefore, it ruled that the grantor's retained power will not cause the value of the trust corpus to be included in his/her gross estate under either Sections 2036 or 2038.

C. Qualified Personal Residence Trusts.

1. A Qualified Personal Residence Trust or "QPRT" is an irrevocable trust that holds a personal residence for a term of years. At the end of the trust term, the residence is distributed to the beneficiaries named in the trust—typically children. For example, John creates a QPRT and transfers his residence to the QPRT for a term of 12 years, with the remainder passing to his children. John has the right to live in the residence and to use the residence for the next 12 years. At the end of the 12-year term, the residence passes to John's children.

2. There are several tax and economic benefits associated with a QPRT. QPRTs are especially well suited at leveraging a client's estate and gift tax credit. A transfer of property to a QPRT is currently treated as a taxable gift. The value of the gift is based on the present value of the remainder beneficiary's right to receive the property at the end of the QPRT term. For example, John, age 65, creates a QPRT and transfers his residence to the Trust for a term of 12 years, with the remainder passing to his children at the end of the 12-year term. Assuming the residence is valued at $1,000,000 and the transfer is made in September 2006, based on IRS tables, John is treated as having made a gift to his children valued at $346,060. This is the first place where there is a significant tax savings.
John has effectively transferred an asset worth $1,000,000 to his children by using only $346,060 of his $1,000,000 gift tax exemption equivalent.

3. Another tax and economic benefit is that all of the future appreciation of the residence will be transferred to the children estate and gift tax-free. A QPRT, as a result, is a powerful estate freezing tool. Based on the prior example, assuming that the $1,000,000 residence appreciates at 4% per year for the 12-year term, the residence will be valued at $1,601,032. All of the appreciation during the 12-year term inures to the benefit of the children. Therefore, by making a gift, valued for estate and gift tax purposes at $346,060, John will effectively transfer an asset worth $1,601,032. Assuming John's estate is in the 45% estate tax bracket, this produces an estate tax savings of $564,737.

3. A gift to a QPRT is a gift of a future interest and does not qualify for the gift tax annual exclusion, currently $12,000 per person per year. Only gifts of a present interest qualify for the $12,000 gift tax annual exclusion. A gift to a QPRT is subject to an ETIP (estate tax inclusion period) during which GST exemption cannot be allocated. GST exemption can be allocated at the expiration of the QPRT, but the value may be uncertain and the GST exemption may be insufficient to cover the full amount of the transfer. Therefore, QPRTs are not terribly effective for GST type transfer. In drafting the QPRT, it is important to structure the remainder interest so that it passes to non-skip persons only.

4. The term of the QPRT is an important factor in determining the tax consequences of a QPRT. As the QPRT term grows longer, the gift to the remainder beneficiaries grows smaller, and the tax savings is greatly improved. The table below shows the tax results and savings for a $1,000,000 residence transferred to a QPRT, in September 2006, for varying terms:

<table>
<thead>
<tr>
<th>QPRT Term</th>
<th>Current Value of Gift</th>
<th>Future Value at End of Term</th>
<th>Potential Estate Tax Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 years</td>
<td>$670,560</td>
<td>$1,216,653</td>
<td>$245,742</td>
</tr>
<tr>
<td>10 years</td>
<td>$424,480</td>
<td>$1,480,244</td>
<td>$475,094</td>
</tr>
<tr>
<td>15 years</td>
<td>$247,070</td>
<td>$1,800,944</td>
<td>$699,243</td>
</tr>
</tbody>
</table>

5. The value of the retained interest is valued based on the Code § 7520 rate in effect for the month in which the QPRT is created and funded. When interest rates are higher, the value of the retained interest is higher and, thus, the value of the remainder is lower. Therefore, QPRTs are especially effective when interest rates are high. The following chart illustrates the effect of interest rates.
6. If the client dies during the term of the QPRT, the residence is included in your estate at its full fair market value at the time of year death. The benefit of the transaction is lost, but you are no worse off than if you did not create a QPRT, other than transactional costs in establishing the QPRT. For example, Mary, age 50, creates a QPRT with a 15 year term and transfers her $1,000,000 house to the QPRT. Mary dies 14 years and 11 months later when the residence is valued at $1,800,944. The value of the residence is included in Mary’s estate at $1,800,944. However, she does receive a credit for the initial gift to the QPRT.

7. The term is selected by the client/donor. Because of the negative tax consequences of dying before the expiration of the QPRT term, we will typically review the actuarial tables and life expectancy of the client and use approximately 2/3rds of the client’s life expectancy. For example, an average individual age 65 has a life expectancy of 17.2 years. As a result, we will use a QPRT term of no greater than 12 years. Obviously, we discuss any known health problems and family history with the client and may make adjustments to the QPRT term, as appropriate, based on those discussions. If you outlive the term of the QPRT, the residence passes to the remainder beneficiaries. They are the owners of the property. You can, however, lease the property back from the remainder beneficiaries at a fair market value rent. The obligation to rent your residence back from your children can be viewed, by some, as a negative feature; however, many clients view it as an opportunity to transfer additional assets, via rent payments, to their children. IRS Private Letter Rulings have sanctioned QPRTs which included mandatory fair market lease provisions at the end of the QPRT term. See, e.g, PLR 9249014, PLR 9827037, and PLR 199918042.

8. One can minimize the income tax consequences associated with the payment of rent by using a grantor trust. Upon the expiration of the QPRT term, the residence can pass into a trust, structured as a grantor trust for income tax purposes under the grantor trust rules of Code § 671-677, to cause the client/grantor to be treated as the owner of the trust. The effect is that when the client pays rent to the trust, the rent is non-taxable, since the client is paying rent to himself/herself. See Rev. Rul. 85-13.
9. You are allowed to transfer your principal personal residence and one vacation home to a Qualified Personal Residence Trust. You are allowed to have only one principal residence, but you can have two personal residences (one of which is your principal residence). Yes. If you own two personal residences, you can transfer each residence to a QPRT. In addition, you can transfer fractional interests in your personal residence to multiple QPRTs. This can be used to hedge against the possibility of a premature death. For example, Steve creates four QPRTs with terms of 4, 8, 12, and 16 years. Steve transfers a 25% interest in his residence to each of the QPRTs. If Steve dies after 14 years, only the 25% interest in the last QPRT (with the 16 year term) is included in his estate.

10. It is not uncommon for a husband and wife to own their property jointly or as tenants by the entirety with the right of survivorship. In this case, we will divide the property into two 50% tenant in common interests. Each spouse will create a QPRT and will transfer his or her 50% interest to the QPRT. The Courts have consistently upheld valuation discounts for fractional interests in real estate and it is not uncommon to receive discounts of 20% or more. Under these facts, each of the 50% interests valued at $500,000 would be discounted to $400,000 and would produce an even better tax result. The chart below compares the tax savings of the transfer of 2 50% interests with a 100% interest.

<table>
<thead>
<tr>
<th>Initial Value of Asset</th>
<th>Current Value of Gift</th>
<th>Future Value at End of Term</th>
<th>Potential Estate Tax Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000,000</td>
<td>$346,060</td>
<td>$1,601,032</td>
<td>$564,737</td>
</tr>
<tr>
<td>$800,000</td>
<td>$276,848</td>
<td>$1,601,032</td>
<td>$595,883</td>
</tr>
</tbody>
</table>

1. Two 50% interests each valued at $500,000 and discounted by 20%. 2 x ($500,000 x (1 - 20%)) = $800,000

11. Only a personal residence can be transferred to a QPRT. If there is substantial excess acreage that is not related to the residence, the additional land and buildings may not qualify as a QPRT. The IRS has ruled in several Private Letter Rulings that estate-type residences and the attendant outbuildings, guest cottages, and acreage may qualify as a personal residence. The rationale is that a person who purchases an estate type residence normally expects to have the attendant acreage, outbuildings, etc. and, thus, gave these favorable rulings. Each property should be determined on a case by case basis. See, e.g., PLR 9817004, PLR 9818014, PLR 9827037, PLR 200617035, and PLR 200626043.

12. Ordinary and recurring expense associated with the residence, such as real estate taxes, hazard insurance premiums, and minor repairs may be paid
by the client/donor. The client can deposit the funds necessary to pay these amounts with the Trustee. The Trustee is permitted in a QPRT to retain sufficient funds to pay these amounts. A QPRT is treated as a grantor trust for income tax purposes and, thus, the client/donor can deduct the real estate taxes paid on his or her personal income tax return. In the event a capital improvement is made to the residence by the client/donor, this will be treated as an additional gift to the QPRT and the amount of the gift will be based on the value of the capital improvements and the remaining term of the Trust.

13. If the residence is sold while held in the QPRT, the proceeds can be reinvested in a new residence. Since a QPRT is a grantor trust, any gain recognized on the sale of a principal residence should qualify for the $250,000/$500,000 exclusion of gain from the sale of a principal residence, provided all of the other Code § 121 requirements are met. The exclusion of gain does not apply to the sale of a personal residence that is not a principal residence, such as a vacation home. If the proceeds of sale are not reinvested in a personal residence, the QPRT will convert to a Grantor Retained Annuity Trust or "GRAT" and will pay an annuity to the client/donor for the balance of the QPRT term.

14. Several years ago, the IRS issued regulations which prohibit the client/donor or their spouse from purchasing the residence from the QPRT. The benefit of this type of transaction is that (i) it avoids the loss of the step up in basis, and (ii) the client is not required to rent the residence from his or her children. Before the issuance of the regulations, a client/donor could purchase the residence back from the QPRT shortly before the expiration of the QPRT term for its then full fair market value. As a result, the remainder beneficiaries would receive cash equal to the purchase price paid and the client/donor would receive the residence back in his or her own name. The QPRT Regulations now require that the trust instrument specifically prohibit a donor or their spouse from re-acquiring the residence.
XXI. STATUTORY ESTATE TAX RELIEF.

A. Alternate Valuation.

1. General Provisions. Code § 2031 provides that the value of a decedent's gross estate is the fair market value of all of the decedent's property as of the date of his or her death, unless the "alternate valuation method" under Code 2032 is elected. Code § 2032 provides that "the value of the gross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate... as of the date 6 months after the decedent's death."

2. Exceptions. There are two exceptions to this rule:

   a. If the decedent's property that is distributed, sold, exchanged or otherwise disposed of within six months after date of death, such property is valued as of the date of such distribution, sale, exchange or other disposition, and

   b. If any interest in the decedent's estate which is affected "by mere lapse of time," such interest is valued as of the decedent's date of death with adjustments for any valuation differences not due to mere lapse of time as of the appropriate alternate valuation date.

3. Distributed, Sold, Exchanged. The phrase "distributed, sold, exchanged, or otherwise disposed of" includes all possible ways by which property ceases to be part of a decedent's gross estate, but does not include transactions which are mere changes in form.

4. Mere Lapse of Time. Property interests that may be affected by a mere lapse of time include "patents, estates for the life of a person other than the decedent, remainders, reversions, and other like properties, interests or estates." Any interest or estate which is affected by mere lapse of time shall be included at its value as of the time of death (instead of the later date) with adjustment for any difference in its value as of the later date not due to mere lapse of time. Life estates, remainders and other similar interests are valued for alternate valuation purposes using (1) the age of the person whose life may affect the value of the interest as of the decedent's date of death, and (2) the value of the property as of the alternate valuation date, so that the mere lapse of time does not affect the value of the interest.
5. **Deductions.** If alternate valuation is elected, deductions will not be allowed with respect to an asset to the extent that such deductions are already taken into account in determining the alternate value of that asset. Additionally, charitable and/or marital deduction(s) are valued as of the decedent's date of death and are adjusted for any differences in value (other than changes due to mere lapse of time) as of the earlier of the date of disposition or six months after date of death.

6. **Reduction of Gross Estate and Estate Tax.** The election is available only when both the values of the gross estate and the estate tax (after allowable credits) are reduced. Code § 2032(c). This provision was added to discourage the executor's election of an alternate valuation date merely to reduce a beneficiary's income tax liability upon a later sale of the property. In such instances, the election was an abuse of the underlying purposes of Code § 2032 to reduce the overall estate tax liability when assets had declined in value after the decedent's death.

7. **Must File Return.** The election is not available if a federal estate tax return is not required to be filed. If no federal estate tax return is required, determine whether an alternate valuation election is allowable under local law. The election is not available if the "optimum" marital deduction formula clause is used, since there would be no tax to be reduced.

8. **Making the Election.** The election may be made on an estate tax return filed any time within one year after the time prescribed by law (including extensions) for filing such returns. Code § 2032(d)(2). Thus, the election can be made up to 27 months after death. The election is irrevocable. § 2032(d)(1). The election is made by checking "Yes" to the box on line 1, page 2 of the Form 706 under the "Elections by the Executor."

**B. Code § 6166 – Installment Payment of Estate Tax.**

1. To ease some of the financial hardship created when a closely held business constitutes the majority of the decedent's estate, an executor may elect to pay the estate tax owed over a 14-year period, if certain requirements are met. See Code § 6166.

2. The executor of the estate may elect to completely defer the estate tax for a period of up to five years and subsequently pay the tax in up to ten annual installments. Code § 6166(a).

3. For estates of a decedent dying after December 31, 1997, the estate must pay interest at the rate of two percent per year on the portion of the deferred tax attributable to the first $1 million ($1,280,000 in 2008; $1,330,000 in 2009) of closely held business property. Code § 6601(j).
However, the interest paid on the deferred estate tax is not deductible. Code §§ 163(k), 2053(c)(1)(D), 6601(j)(1)(A).

4. Where an executor of an estate of a decedent who died prior to January 1, 1998, has made an election under Code § 6166, the executor can elect to have the new 2% rate applied to the remaining payments. Revenue Procedure 98-15 sets forth the procedure for making an election to have the lower interest rate apply to the remaining payments. The interest rate imposed on the amount of the deferred estate tax attributable to the taxable value of closely held business property in excess of $1 million is 45 percent of the rate generally applicable to underpayments of tax, and this amount is also not deductible. Code §§ 163(k), 2053(c)(1)(D), 6601(j)(1)(B).

5. Beginning in 1999, the $1 million ceiling on the taxable value of closely held business property eligible for the two-percent rate will be indexed annually for inflation. Code § 6601(j)(3). For decedents dying in calendar year 2008, the ceiling has been raised to $1,280,000; this amount is $1,330,000 in 2009. Any remaining interest is charged to the estate at the rate typically charged for estate tax deficiencies. This rate is adjusted quarter-annually and is based on the short-term federal rate plus three percentage points. Code § 6621(a), (b). An estate planner should consider these changes when determining the liquidity needs of a closely held business owner.

6. In order to be eligible for the tax deferral election, the value of the interest in the closely-held business must be at least 35 percent of the value of the gross estate reduced by the expenses, indebtedness and losses of the estate. If the estate owns at least a 20 percent interest in more than one business, these interests may be aggregated for the purpose of satisfying the 35 percent test. Code § 6166(c). The tax deferral allowed by Code § 6166 applies only to interests in closely-held businesses as defined by the section. A decedent owns an interest in a closely-held business under this section if the decedent is one of the following:

   a. A sole proprietor; or

   b. A partner in a partnership with no more than 15 partners, or where 20 percent or more of the total capital interest in such partnership is owned by the decedent; or

   c. A shareholder who owns 20 percent or more in value of the voting stock of a corporation, or such corporation has 15 or fewer shareholders. Code § 6166(b)(1).
7. When determining whether there are 15 or fewer shareholders or partners in a corporation or partnership respectively, all stock or partnership interests owned by the decedent’s brothers, sisters, spouse, ancestors, and lineal descendants are deemed to be owned by the decedent. Code § 6166(b)(2)(D). Likewise, in determining whether the 20 percent value test is met, the decedent not only owns his or her own stock or partnership interest, but is also deemed to own the interests held by his or her brothers, sisters, spouse, ancestors and lineal descendants. Code § 6166(b)(7).

8. In addition, the decedent must have been engaged in an active trade or business, not a passive investment activity. The management of investment type assets does not qualify as a trade or business. See Rev. Rul. 75-365, 1975-2 C.B. 471; Rev. Rul. 75-366, 1975-2 C.B. 472; Rev. Rul. 75-367, 1975-2 C.B. 472; Letter Rul. 8240055.

9. The tax deferral election to pay the estate tax in ten installments must be made within the time allowed for filing the estate tax return, which is, nine months from the decedent’s death, including any extension of time granted for the filing of the return. Code § 6166(d).

C. Service Must Exercise Discretion in Requiring Bond or Special Lien.

1. In Estate of Edward P. Roski Sr. et al. v. Commissioner, 128 T.C. No. 10 (Apr. 12, 2007), the Tax Court held 1) that it has jurisdiction to review an IRS determination denying an estate’s election under Code § 6166 to pay its taxes in installments, and 2) that the IRS abused its discretion in making that determination, because the IRS does not have authority to require a bond or special lien in every case under Code § 6166.

2. The executor of the Roski estate (the “Estate”) filed a timely estate tax return and attached a notice of election under Code § 6166 to defer payment of the tax owed. The IRS notified the Estate that because of the election, it would be required to either post a bond or provide a special lien under Code § 6324A. The Estate responded by requesting that the IRS exercise its discretion and not require the Estate to post a bond or provide a special lien. In support of this request, the Estate cited the following facts:

a. the Estate was unable to find a company to post the bond;

b. the well-established business that was part of the Estate provided assurance that adequate funds would be available to pay the Estate tax liability, thereby mitigating any default risks;

c. the executor was a highly respected businessman who at all times had fulfilled his tax obligations;
d. the government already had security under the Code § 6324 lien; and
e. the imposition of a special lien would have negative effects on the Estate's business.

3. Nonetheless, the IRS issued a notice of determination denying the election, because the Estate failed to provide the bond or special lien. The Estate filed a petition with the Tax Court for a re-determination and judgment that it was entitled to the election. The IRS filed a motion for summary judgment, arguing that Code § 7479 does not give the Tax Court jurisdiction to review the IRS' denial of the election. The Estate objected to this motion and filed a cross-motion for summary judgment, arguing 1) the IRS' refusal to exercise its discretion by requiring a bond in every case was an abuse of discretion and 2) the undisputed facts established that if the IRS had properly exercised its discretion, no bond or special lien would have been required.

4. The Tax Court denied the IRS' motion for summary judgment. In support of its decision, the Court pointed to the "strong presumption that the actions of an administrative agency are subject to judicial review." The Tax Court also rejected the IRS' argument that Code § 7479 only provides for review of the eligibility requirements for a Code § 6166 election, and not the actual bond requirement of Code § 6165, finding that Code § 6165 is included by reference in Code § 6166.

5. The Tax Court then determined that the IRS had abused its discretion in applying a bright-line rule that an estate must provide a bond or special lien. In support of this conclusion, the Tax Court noted the following:

a. the IRS has changed its position four times in the last 15 years regarding the bond requirement under Code § 6166; and

b. neither the plain language nor the legislative history of Code §§ 6166 and 6165 indicate that a bond is mandatory.

6. The Court, however, refused to grant the Estate's motion for summary judgment, holding that the facts on the record were insufficient to allow it to make such a determination.


1. In response to Roski, the IRS issued Notice 2007-90 in which it provided interim guidance that would set standards to be applied on a case-by-case basis for determining whether security will be required when an estate elects to pay the estate tax in installments. The Treasury Department and
the IRS are in the process of establishing standards to be applied on a case-by-case basis in the future to identify those estates making an election under section 6166 in which the government's interest in the deferred estate tax and the interest thereon is deemed to be sufficiently at risk to justify the requirement of a bond or special lien. The Treasury Department and the IRS intend to issue regulations implementing those standards and related procedures. Until those regulations are issued, however, the IRS will evaluate the factors described below and all other relevant facts to determine on a case-by-case basis whether, at any time and from time to time during the deferral period, the government's interest in the estate tax deferred under section 6166 and interest thereon is sufficiently at risk to justify the requirement of a bond or special lien.

2. In order to determine whether the government's interest in the deferred tax is adequately secured up to the amount allowed under sections 6165 and 6324A, the IRS will consider information contained in the estate tax return, attachments to the return, information obtained during examination in audited cases, and any other relevant information. Estates that have filed returns that do not contain adequate information to make this determination may be contacted and required to provide additional financial information to the IRS for purposes of making this determination. The IRS may terminate an estate's election for failure to respond to such requests within a reasonable timeframe. If, after this individual evaluation and analysis, the IRS determines there is a sufficient credit risk regarding the government's collection of the estate tax payments deferred under section 6166 and the interest thereon, the IRS will notify the estate that it must provide a bond or elect to provide a section 6324A special lien in lieu of a bond. If the estate then refuses to provide a bond or a section 6324A special lien, the IRS will terminate the estate's section 6166 election. The estate may then seek reconsideration of the termination by the Office of Appeals and, if the Office of Appeals upholds the IRS's determination, the estate then will have the opportunity to petition the Tax Court under section 7479 for a declaratory judgment with regard to whether its section 6166 election may be continued. I.R.C. § 7479; Rev. Proc. 2005-33, 2005-24 I.R.B. 1231. The factors the IRS will consider in determining whether deferred installment payments of estate tax under section 6166 pose a sufficient credit risk to the government to justify the requirement of a bond or special lien are described below. In making this determination, the IRS will consider all relevant facts and circumstances, in addition to the factors identified in the following, non-exclusive list. No single factor will be determinative, and not all factors may be relevant to every estate.

a. **Duration and stability of the business.** This factor considers the nature of the closely held business on which the estate tax is deferred under section 6166 and of the assets of that business, the
relevant market factors that will impact the business's future success, its recent financial history, and the experience of its management, in an effort to predict the likelihood of its success and survival through the deferred payment period. Facts relevant to this factor are likely to appear primarily in the appraisal and the financial statements that accompany the estate tax return. Information regarding any outstanding liens, judgments, or pending or anticipated lawsuits or other claims against the business, if any, that are not disclosed in that documentation should be provided by the estate with the election. The estate may be required to furnish such information in response to an inquiry by the IRS.

b. **Ability to pay the installments of tax and interest timely.** This factor considers how the estate expects to be able to make the annual payments of tax and interest as due, and the objective likelihood of realizing that expectation. Facts relevant to this factor may include the nature of the business's significant assets and liabilities, and the business's cash flow (both historical and anticipated). If not sufficiently disclosed in the documents attached to the estate tax return, the estate should submit relevant information with the election under section 6166. The estate may be required to furnish such information in response to an inquiry by the IRS.

c. **Compliance history.** This factor addresses the business's history regarding compliance with all federal tax payment and tax filing requirements, in an effort to determine whether the business and its management respect and comply with all tax requirements on a regular basis. This factor also addresses the estate's compliance history with respect to federal tax payment and filing requirements. The estate may use a sworn affidavit or other probative documents to provide this information.

4. The notice is applicable to each estate: (1) that timely elects to pay the estate tax in installments under section 6166 and that timely files a return on or after November 13, 2007; (2) whose return was being classified, surveyed or audited by the IRS as of April 12, 2007; or (3) that is currently in the deferred payment period but that has not yet provided a bond or special lien if (a) the general federal estate tax lien will expire within two years from November 13, 2007 or (b) the IRS reasonably believes that the government's interest in collecting the deferred estate tax and interest thereon in full is sufficiently at risk to require a bond or special lien.
E. **Special Use Valuation.**

1. Code § 2032A provides an alternative method of valuing real estate used in a farming business or other closely-held business if such property constitutes a substantial part of the estate's total assets. See Code § 2032A. If this "special use" valuation method is elected, the value of the real property included in the estate under this method may be up to $750,000 less than the property's fair market value. See Code § 2032A(a)(2). The $750,000 amount is indexed for inflation and in 2004, the limit is $850,000; in 2005, the limit is $870,000; in 2006, the limit is $900,000; in 2007, the limit is $940,000; in 2008, the limit is $960,000; in 2009, the limit is $1,000,000.

2. The real estate in question must pass from the decedent to a "qualified heir." This heir can either inherit it or buy it from the estate. Qualified heirs include the decedent's ancestors (parents, grandparents), spouse, and lineal descendants (children, grandchildren). They also include the lineal descendants of the decedent's spouse or parents, and the spouses of the lineal descendants.

3. For five of the eight years leading up to the decedent's death, the realty must have been used in a farm or family business on or in which the decedent or a family member worked ("materially participated").

4. The real and personal property in the business or farm included in the decedent's estate has to comprise at least 50% of the gross estate, and the real property in the business or farm included in the decedent's estate has to comprise at least 25% of the gross estate. (For these purposes, the realty is valued at its "high" value, e.g., $1 million in the example given in the first paragraph above.) In meeting these tests, two or more qualifying businesses can be combined as long as they all have real estate included in the decedent's estate.

5. The qualified heir must consent (with IRS) to be liable for all of the estate taxes saved if, within ten years, the property is transferred to anyone other than a qualified heir (of the first qualified heir) or if the property stops being used for the qualified purpose (for example, if it's sold to an outsider or is developed by the family as a shopping mall).

6. Even if the property qualifies for special use valuation, the property's value can't be reduced by more than $960,000 (for estates of decedents dying in 2008) and 1,000,000 (for estates of decedents dying in 2009).
XXII. FINANCING THE PAYMENT OF ESTATE TAX.

A. Graegin Loans.

1. Code § 2053 provides, that the value of the taxable estate shall be
determined by deducting from the value of the gross estate amounts for
administration expenses.

2. Treas Reg. § 20.2053-1(b)(3) provides that items may be entered on the
return as a deduction even if the exact amount is not then known provided
it is ascertainable with reasonably certainty, and will be paid. Treas Reg. §
20.2053-3(a) provides that “amounts deductible from a decedent’s gross
estate as administration expenses [and are] limited to such expenses as are
actually and necessarily incurred in the administration of the decedent’s
estate”. A loan obtained by an estate may be necessary to pay
administration expenses of the estate in limited circumstances. Below is a
summary of the authority regarding loans obtained by an estate to pay
estate taxes and other expenses of estate administration.

out by the estate from a wholly-owned subsidiary of the closely-held
company in which the decedent held stock. The decedent’s son was
president of both companies. The term of the loan ran for fifteen (15)
years at 15% simple interest (which was the prime rate on the day the loan
was taken out), and the loan provisions contained a provision against early
repayment. A 15 year loan term was selected because 15 years was the
actuarial value of the life expectancy of the widow, whose estate would
have contained enough assets to repay the loan in full. The Tax Court
held in Graegin that the interest on the loan was deductible as an
administrative expense when the debt was incurred. The deductions for
interest amounts paid on the loan were limited to amounts that were
certain to be paid.

4. Loan terms that have passed scrutiny for the same purpose have
consistently had the following features (1) the loan was necessary due to
the illiquidity of the estate, (2) the interest expense was subject to
reasonable estimation, (3) the loan was bona fide in the sense that it had an
economic impact, (4) the lender was accruing interest so that both parties
were treating it consistently, and (5) the ability to borrow the funds was
authorized by local law. In determining whether the loan is necessary, the
decedent’s estate could not obtain operational lines of credit because of
the tax lien under Code § 6166, and determined it was in the best interest
of the closely-held company of which the decedent owned to take out a
loan. The loan was secured, and taxes paid, and the Service allowed the
estate and lender to amend the loan documents to provide the loan could
not be prepaid. Additionally, the Service noted that the loan, while
benefiting a beneficiary of the estate, was necessary to preserve a significant asset of the estate. Priv. Ltr. Rul 200020011.

5. Examples of permissible terms are contained in Priv. Ltr. Rul 199952039 where the Executor took out a ten (10) year fixed interest loan from a commercial lender, the terms of the loan did not allow for prepayment, and there was a balloon payment feature.

6. In Priv. Ltr. Rul 200449031, the Executor took out a commercial loan with terms that provided prepayment as an option feature (which the Executor could and did opt out of) and the estate was allowed the deduction for the principal and interest amounts.

7. In Priv. Ltr. Rul 199903038, the Executor took out a fixed-interest rate loan for a term of seven (7) years with no prepayment ability and the estate was allowed a deduction for both principal and interest subject to prior approval of the loan by the state court as required by local law.

8. A California state court case, Klein v. Hughes, 2004 WL 838198 (Cal. Rptr. 2004) involved an estate with an estimated tax liability of $212,460,485. The executors of the estate negotiated with the Service a proposal that would have allowed the estate to obtain a loan in the amount of $49 million, that would carry an interest rate of 8.75%, with all unpaid principal and interest due on December 31, 2027 (a 25 year term). No interest payments would be required for the loan aside from a $10 million payment due in September, 2005, and prepayment of the amounts were prohibited. It was determined the trust would incur a total of $309 million in deductible interest expense by the due date, which would reduce the estate’s liability for estate tax by $166.5 million. The assets in the gross estate were limited liability companies from which the estate had no power to compel cash distributions and which were subject to stringent restrictions on transfer. The Service approved the structure of the loan informally in a Closing Agreement, with the stipulation that the lender was not a related entity or an entity controlled or owned by the estate. The case did not discuss whether the proposed structure was permissible under applicable tax law, but whether the petition to the court for permission to engage in the transaction was to be granted over the objection of the parent of the minor beneficiary of the estate and therefore is not an example of a fact pattern that can be modeled without obtaining prior approval from the Service.

9. Factors that lead to negative rulings or increased scrutiny in this area are (1) a relationship between the estate and the lender, (2) use of the funds, or a portion thereof, for a purpose other than payment of estate tax or state tax liability, (3) and failure to show the loan was necessary to preserve an
asset of value of the estate. These are not always determinative factors, but their presence will cause the closer scrutiny by the Service.

10. The IRS has issued a Litigation Guideline Memoranda (LGM) discussing their position on these loans, which is reflected in the arguments presented by the Service before the Tax Court in the Gilman and McKee cases as discussed below. The LGM concedes the position taken by the court in Graegin, but directs agents to examine the substance of a loan between related parties and the treatment by the lender of the interest. The taxpayer must show that the interest is certain to be paid and that the lender is accruing the interest. Additionally, the taxpayer must show facts that indicate the loan is necessary and the terms of the loan are reached at arms-length. The Service is directed to examine “unusual financing techniques” such as “unsecured loans, high rates of interest, long terms, …and whether less expensive lending alternatives were available from third party sources.”

11. In Tech. Adv. Mem. 200513028 the estate was not allowed to deduct the principal and interest of the loan as an administrative expense because the Service did not think the loan payments would ever be paid to the lender, thereby causing no economic impact. The facts presented in Tech. Adv. Mem. 200513028 had the estate executing a promissory note which would allow the estate a line of credit up to a designated amount, with a fixed interest rate (which was at least one percent (1%) above the then existing prime rate) and a term of 10 (ten) years, with no prepayment allowed. However, the lender was a family limited partnership (“FLP”) in which the estate was a ninety-seven percent (97%) partner and the decedent’s child was the remaining partner and co-executor of the estate. The Service determined that this arrangement did not have an economic impact on the parties and was not necessary to preserve an estate asset because the FLP was not engaged in any active business that would necessitate the retention of liquid assets available to use to pay the estate tax.

12. In McKee, et al v. Commissioner, TC Memo 1996-362, the Tax Court determined the estate could deduct the interest on loans it obtained from the decedent’s closely-held corporation to pay estate taxes as an administrative expense. The executors of the estate were also the directors of the closely-held company. The executor in this case borrowed an amount from the closely-held corporation in exchange for an unsecured demand note bearing an interest rate of eleven percent (11%) for a term of eight-five (85) days. These proceeds were applied with assets that were disclaimed by the surviving spouse toward the payment of the estate tax due. The intention was for the executors to repay the loan as soon as the buy-sell agreement could be amended to enable the pledge of the company shares in connection with a loan having a longer term obtained from a third party. A complicated series of transactions occurred that involved a
third party loan, a redemption of the company stock, and two more subsequent loans from the company. The Court determined that all interest expenses on the four loans were deductible as administration expenses because the executors were faced with a liquidity problem and would otherwise have been forced to sell a large block of stock to pay the estate tax. While the Court decided the case in favor of the estate-taxpayer, the facts presented by this case demonstrate the burden an executor must prove if the loan used to pay the estate tax is from a closely-held company or between related parties.

13. The Service recently challenged a loan taken out by an estate when the interest payment was larger than necessary due to the amount borrowed and due to a term that was deemed to be unreasonably long. In Estate of Gilman, et al. v. Commissioner, TC Memo 2004-286, the estate borrowed money to pay estate tax under a loan with a term of ten (10) years, a fixed interest rate, and no ability to prepay. The executors of the estate were also the managers of the decedent’s limited liability company, officers of the decedent’s closely-held corporation and members of the board of directors of the charitable foundation set up by the decedent. The Court determined that the loan’s necessity was short-term in length, and disallowed deductions taken for the loan amounts used to compensate the executors in their capacity as directors and officers. The decedent’s will expressly prohibited compensation for the executors. The executors elected to pay the estate tax in full, rather than make a Code § 6166 election based on tax advice from counsel. The Court agreed that the amount borrowed to pay the estate tax was necessary due to the reduction in cash flow of the businesses during the course of the administration of the estate and the liquidity of the estate, but the funds borrowed to pay the compensation of business consultants, the officers of the company or other administration expenses were not necessary as estate administration expenses and therefore not eligible to be deducted. Principal and interest amounts relating only to the portion of the loan related to payment of the estate tax were permitted as a deduction.

14. If an estate is presented with a liquidity problem, the principal and interest on a loan obtained by the estate to pay for estate tax may be deductible if the following facts or factors can be shown:

a. The loan is a necessary expense of the estate due to the nature of the asset contained in the estate or the liquidity of the estate.

b. The loan term is not unreasonably long.

c. The amount of interest claimed as a deduction is within the parameters of a loan that is commercially available to the estate considering the date, term, and security offered.
d. The loan is a bona-fide arms-length arrangement that will have an economic impact on the lender and the estate.

15. Related party loans have been allowed, but they will likely require the estate to bear a greater burden in proving the necessity of the loan. The structure of the loan can be either annual payments of principal and interest for a fixed term or contain a balloon payment, as long as the amount of the interest claimed as a deduction is readily ascertainable. The term of the loan should reflect a business reason for the selection of the length of the term, such as when the executor reasonably expects to have funds to pay the loan due to expected cash flow, life expectancy or the timing of a business transaction concerning an asset of the estate.

B. Life Insurance.

1. Many clients are unwilling to undertake the uncertainty or complexity associated with the tax benefits associated with Code §§ 303, 2032A, former 2057, or 6166. As a result, they will plan to ensure estate liquidity through the purchase of life insurance.

2. In many cases, the insurance policy will be purchased through an irrevocable life insurance trust. The trust will be designed to avoid the business owner-insured's retention of any incidents of ownership over the insurance policy. If properly drafted and structured, the trust will receive the insurance death benefits estate tax free.

3. Typically, the business owner will gift premiums to the trust. The beneficiaries of the trust will have Crummey withdrawal powers, designed to qualify for the gift tax annual exclusion. Assuming the Crummey withdrawal powers are not exercised, the Trustee of the trust will use the gifted funds to pay the premiums on the life insurance policies.

4. In drafting the trust agreement, it is important not to obligate the trustee to use funds in the trust to pay any of the costs of administration or federal estate taxes or state death taxes owed by the estate of the insured (or the estate of the survivor of the husband and wife in the case of a second-to-die policy). However, the trustee can and should be given the right either to lend money to or to purchase assets from the estate of the insured and the estate of the insured’s spouse. The agreement should provide that any loan to the estate of the insured or the insured’s spouse be properly secured and adequate interest be paid and that the purchase of assets be made for full and adequate consideration in money or money’s worth.

5. The purchase of assets by the irrevocable trust from the estate should result in little or no taxable income to the estate, since the estate will
receive a step-up in basis for income tax purposes for assets included in the decedent’s gross estate.

XXIII. CHARITABLE GIFTS OF REAL ESTATE AND REAL ESTATE INTERESTS.¹

A. Introduction.

1. Real estate owners may wish to contribute real property to charity, either in the form of gifts of fee simple interests in land and buildings or gifts of partial interests such as conservation easements. Charitable gifts of real property or interests in real property must meet specific guidelines in order to qualify for income, gift and estate tax deductions.

2. When making charitable gifts of real estate (or interests in real estate), either directly or through entities, the taxpayer should be aware of both the opportunities and the pitfalls that arise as a result of the unique nature of real estate.

3. In general, a donation of property to a charitable organization will give rise to a tax deduction for the donor; however, the amount of the deduction available to the donor, for income and gift tax purposes, or for estate tax purposes, depends upon the nature and value of the property being transferred.

4. Certain sale transactions may also be governed by the rules for charitable contributions if the sale price is less than the fair market value of the property.

5. What follows will be a summary of the rules regarding the making of tax-deductible charitable contributions and the tax deductions that are available to a taxpayer, as well as some of the charitable giving techniques which can benefit the charity, the taxpayer and the taxpayer’s family.

B. Requirements for a Charitable Contribution. There are two elements to be considered in determining whether a transfer of property is a charitable contribution.

1. First, the property must be transferred to a charitable entity to be used for charitable purposes as set forth in the Internal Revenue Code. Reg. §1.170A-7(c).

¹ This section on charitable gifts of real estate and real estate interests is derived from Mary Ann Mancini and Stefan F. Tucker’s outline entitled, “Estate Planning for Real Estate Owners.” I am deeply indebted and grateful to Mary Ann and Stef for sharing this portion of their excellent materials with me.
2. Second, the transfer must be intended as a gratuitous gift. The rules regarding whether a gift of property is gratuitous have been developed mainly through court decisions.

3. In order for a charitable contribution to be deductible, it must be a gift, contributed out of a “detached and disinterested generosity, out of affection, respect, admiration, charity and like impulses.” Reg. §1.170A-7(c). A transfer which lacks donative intent is not a charitable contribution. A transfer lacks donative intent if it is a contribution made pursuant to a moral or legal duty or in order to receive an economic benefit. Reg. §1.170A-7(c). In *Stubbs v. United States*, the Ninth Circuit found that the taxpayers did not make a charitable contribution where they deeded property to the City of Tucson for a public road with the expectation that they would receive favorable zoning (otherwise uncertain) and that their remaining property would have guaranteed public access and public street frontage. In a similar case, a conveyance lacked donative intent where, in return for the conveyance, the taxpayers received some cash, other land, relief from an assessment, dismissal of pending condemnation suits and a variance in zoning with respect to their remaining property. Reg. §1.170A-7(c).

4. A contingent transfer, such as a contribution conditioned upon some future occurrence, generally lacks the requisite current donative intent. Reg. §1.170A-7(c).

   a. The Regulations specifically disallow deductions for the transfer of a future interest to a charity where a charity’s interest is dependent upon the performance of some act or the happening of a precedent event in order to become effective, unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.

   b. Similarly, a deduction is disallowed if a transfer of a present interest to a charity could be defeated by the subsequent performance of some act or the happening of some event, unless the possibility of the event occurring is so remote as to be negligible.

   c. For example, if a taxpayer transfers land to a city government for as long as the land is used by the city for a public park, and if, on the date of the gift, the city plans to use the land for a park, and the possibility that the city will not use the land for a public park is so remote as to be negligible, then the taxpayer is entitled to a deduction for his charitable contribution.
C. **Tax Consequences of a Charitable Contribution.**

1. **Non-recognition of Gain or Loss upon Charitable Contribution.** When a taxpayer makes a charitable contribution, within the meaning of Section 170(c), of an interest in appreciated real property to a charitable entity, in addition to being allowed a charitable income tax deduction, as described below, the taxpayer does not recognize any ordinary income or capital gain upon the transfer of the property.

2. Similarly, if the contributed property is loss property, the taxpayer does not recognize any loss on the disposition. As a result of this rule, it is generally more advantageous for a taxpayer who wishes both to dispose of loss property and make a charitable contribution, to sell the loss property in order to recognize the loss and then make a contribution of the proceeds.

3. Whether, and to what extent, a charitable contribution is deductible depends on (i) the timing of the contribution, (ii) general statutory percentage limitations, (iii) specific statutory rules regarding contributions of appreciated property, (iv) the type of interest in the property contributed, and (v) the value of the property contributed.
   
a. A charitable contribution, as defined above, is deductible in a taxable year if it is made during that year. For a corporation that reports its income on the accrual basis, a charitable contribution is deductible in a taxable year if it is authorized by the board of directors of the corporation during that year, and the actual contribution is made on or before the 15th day of the third month following the end of such taxable year.

b. There are percentage limitations on the amount of the income tax deduction a taxpayer may take each year for his or her charitable contribution.

4. **Fifty Percent Limitation.** The basic limitation is that a taxpayer cannot take a charitable contribution greater than 50% of his or her adjusted gross income ("AGI"), computed without any net operating loss carryback. A charitable deduction of 50% of the donor’s AGI is allowed only as follows:

a. The gift may be in the form of cash or property; however, if a gift of property is made, the deduction will be limited to the property’s cost basis, subject to the provisions below.

b. In addition, the gift may be made only to a public charitable organization described in Section 170(b)(1)(A), which includes
churches, educational organizations, affiliated support organizations of educational organizations, medical organizations, governmental units, publicly supported charities (including supporting organizations) and certain private foundations (including private operating foundations).

5. Thirty Percent Limitation. The second percentage limitation on the taxpayer’s charitable income tax deduction is that a taxpayer cannot take a charitable contribution larger than 30% of his or her AGI under the following circumstances:

   a. If the taxpayer makes a charitable contribution to organizations that are not described in Section 170(b)(1)(A);

   b. If the taxpayer makes a charitable contribution that is “for the use of” any charitable organization; or

   c. If the taxpayer makes a charitable contribution of appreciated property, which is “capital gain property”, to a charity described in Section 170(b)(1)(A) and bases his or her contribution on the fair market value of such property, rather than the taxpayer’s cost basis in the property.

6. Twenty Percent Limitation. The last percentage limitation on the taxpayer’s charitable income tax deduction is that a taxpayer cannot take a charitable contribution larger than 20% of his or her AGI if the taxpayer is gifting certain appreciated property to a charitable organization that is not described in Section 170(b)(1)(A) (that is, a private foundation).

7. Carry-forward of Contribution. Gifts in excess of the applicable limitation amounts can be carried forward and deducted in future years until (i) the amount of the contribution is exhausted; (ii) the end of five years following the year of the gift or (iii) the taxpayer dies, whichever occurs first. Secs. 170(d)(1), (b)(1)(B), (C)(ii) and (D)(ii). But see Section 170(b)(1)(E)(ii) for a temporary 15-year carryover period for qualified conservation contributions of real property in 2006 and 2007.

8. Percentage Limitations – Corporations. A corporation may deduct charitable contributions up to 10% of its taxable income, computed without regard to charitable deductions, corporate deductions (except organizational expenditures under Section 248), any net operating loss carryback and any capital loss carryback. Section 170(b)(2).

   a. Like individuals, corporations may carry forward excess charitable contributions for five years.
b. The charitable deduction for corporations is not subject to the distinctions, described above, between types of property and categories of organizations.

9. Limitations Based on the Type of Property Contributed.

a. Certain "Capital Gain Type" Property. Section 170(e) provides for a reduction in either (i) the value of a charitable contribution made by an individual to the individual’s cost basis in the property, or (ii) the percentage limitation of the individual’s AGI from 50% to 30% (or 20% if the charitable organization is not described in Section 170(b)(1)(A)), for the following type of property:

i. Property, the sale of which would have generated ordinary income or short-term capital gain if it were sold for fair market value on the date of contribution.

ii. Tangible personal property, which if sold for fair market value would generate long-term capital gain, and which a charitable (tax-exempt) donee uses for purposes unrelated to its charitable (tax-exempt) purpose.

iii. Property (other than publicly traded stock) which, if sold for fair market value on the date of contribution, would generate long-term capital gain, and is contributed to a private foundation which is not a public charity.

b. For contributions of property to which Section 170(e) applies, the amount of each contribution for purposes of claiming a deduction is reduced by (1) the amount of ordinary income or short-term capital gain which would have been realized had property described in (a) been sold; (2) the amount of long-term capital gain which would be realized if tangible personal property described in (b) were sold for fair market value on the date of contribution; or (3) the amount of long-term capital gain that would be realized on property described in (c).

c. This reduction must be made prior to applying the percentage limitations of Section 170(b).

D. Transfers of Encumbered Property.

1. In general, when a taxpayer contributes encumbered property to a charitable donee, thereby discharging his outstanding obligation, the amount of the discharged obligation is treated as a cash payment from the charitable organization to the taxpayer. See Estate of Levine v. Comm'r, 72
T.C. 780, aff'd 46 AFTR2d 80-5349 (2nd Cir. 1980) (taxpayer recognized taxable gain where contributed property was encumbered beyond taxpayer's basis).

2. The amount of the charitable deduction for such a transaction is the fair market value of the property contributed less the amount of the obligation from which the taxpayer was discharged.

3. When a taxpayer makes a contribution of appreciated encumbered property, the transaction may be treated as if the taxpayer sold the property to the charitable organization for less than its fair market value. For example, in *Ebben v. Comm'r*, 783 F2d 906 (1986), a transfer of encumbered property was recharacterized as a bargain sale. The Tax Court reasoned that, because the taxpayer was relieved of his outstanding obligation when the encumbered property was transferred to the charitable organization, the transaction had the same effect as if the donor had received cash from the organization in return for a portion of the property, making the transfer a deemed sale to the extent of the discharged obligation, and a charitable contribution only with respect to the remaining value of the property.

4. The problem of gain to the donor may be avoided by coupling the transfer with a formal undertaking, by the donor, to satisfy the debt on the property given to the charity as installments come due, thus relieving the donee of the obligation. This would enable the donor to increase his or her charitable contribution to the full fair market value of the property without any reduction for the outstanding debt.

5. Where the property contributed is subject to an outstanding obligation, which is assumed by the donee, and the taxpayer pays interest on the obligation with respect to a period following the date of the contribution, the amount of the charitable contribution is further reduced by the amount of the interest which has been or will be paid by the taxpayer with respect to the obligation and which is attributable to any period after the date of the contribution. This rule was added to the Code in order to prevent the taxpayer from taking both an interest deduction under Section 163 and a charitable deduction under Section 170 with respect to the amount of the interest payments. Example. On January 1, 2004, Alex contributes to a charitable organization real estate having a fair market value and adjusted basis of $100,000. In connection with the contribution, the charitable organization assumes Alex's $80,000 mortgage on the property. On December 31, 2003, Alex prepaid one year's interest on the indebtedness for 2004, amounting to $9,600, and took an interest deduction of $9,600 for the amount. The amount of the contribution without any reduction for interest is $29,600 ($100,000 less $80,000, the outstanding indebtedness, plus $9,600, the amount of prepaid interest). In determining the amount of the deduction for the charitable contribution, the value of the contribution
($29,600) must be reduced by the amount of the prepaid interest ($9,600) to eliminate from the computation of the deduction that portion of the contribution for which Alex has already been allowed a deduction. Reg. §1.170A-3(d), Example (1).

E. Bargain Sales.

1. A bargain sale is a transfer of property which is partly a sale or exchange of the property and partly a charitable contribution. Reg. §1.170A-4(c)(2)(ii). Typically, a bargain sale occurs when an owner of property sells the property to a charitable organization for less than its fair market value. A bargain sale may also be deemed to occur when encumbered property is contributed. In the event of a bargain sale, the seller may be entitled to a charitable contribution deduction based on the difference between the purchase price and the fair market value. See Knott v. Comm’r, 67 T.C. 681 (1977); Waller v. Comm’r, 39 T.C. 665 (1963). However, as with any other charitable contribution, the seller must have the proper intent to benefit the buyer. In general, the rules for determining the deductible amount of a contribution which is made through a bargain sale are the same as for any contribution of a partial interest, which are described below. However, since the taxpayer may be recognizing gain on the sale portion of the transfer, a few additional rules apply.

2. Allocation of Basis. In the case of a bargain sale, the taxpayer’s adjusted basis in the property is determined according to the rules for contribution of a partial interest. See Reg. §1.1011-2(b). Since the transfer is partly a sale, the taxpayer recognizes ordinary income or gain on the portion of the property sold, based on the taxpayer’s basis in the portion of the property sold. In addition, the portion of the ordinary income or gain which would have been recognized had the contributed property been sold at its fair market value on the date of contribution, but which is not recognized by reason of the bargain sale, is applied against the amount of the charitable contribution in accordance with Section 170(e)(1). Reg. §1.170A-4(c)(2)(i). Example. Debbie has a parcel of undeveloped real estate worth $500,000 for which she paid $100,000, that she wishes to donate to a charity. However, Debbie is illiquid and cannot afford to part with the entire value of the asset. Therefore, she sells the property to the charity for $250,000 in cash. Debbie’s basis of $100,000 will be allocated $50,000 to the sale part and $50,000 to the gift part of the transaction. Upon receipt of the $250,000 from the charity, Debbie will have a $200,000 capital gain to report, as well as a $250,000 charitable contribution deduction. Furthermore, in the case of a bargain sale, although the charity’s basis in the purchased property is the fair market value of the property (as is true of any sale), the charity’s basis in the contributed portion of the property is the same as the donor’s adjusted basis in the contributed portion of the property (as is true of any gift).
3. Application of Reduction under Section 170(e)(1). When property is contributed as part of a bargain sale, Section 170(e)(1) applies to reduce the amount of the contribution by the amount of ordinary income or gain realized on the transfer. For purposes of making the reduction, the amount of ordinary income or gain realized on the transfer must be calculated, by allocating first the taxpayer’s basis in the property and then the fair market value of the property. Reg. §1.170A-4(c)(1)(i). The fair market value of the contributed portion of the property is the difference between the fair market value of the entire property and the purchase price of the property. Reg. §1.170A-4(c)(3). The amount of ordinary income or gain realized for purposes of Section 170(e)(1) is then the difference between the fair market value of the contributed portion of the property and the taxpayer’s basis in such portion of the property.

a. Example. Bob transfers property with a fair market value of $100,000 to Charity. Bob has owned the property for 10 years, and his adjusted basis is $40,000. Charity pays Bob $40,000 in accordance with an agreement whereby Charity acknowledged that the property is worth more than $40,000, and that Bob intends to make a charitable contribution of the value of the property in excess of $40,000. Bob’s adjusted basis in the non-contributed portion of the property is $16,000 ($40,000 basis × ratio of $40,000 purchase price over $100,000 fair market value), and Bob recognizes long term capital gain of $24,000 on the portion of the property sold ($40,000 purchase price - $16,000 basis). Bob’s adjusted basis in the contributed portion of the property is $24,000 ($40,000 entire basis less $16,000 basis in portion sold). Assuming Section 170(e)(1)(B) does not apply, the amount of Bob’s charitable contribution is $60,000, the fair market value of the contributed portion.

b. Same facts, except that the transferred property had been held for less than one year, so Section 170(e)(1)(A) applies. The amount of Bob’s charitable contribution will be reduced by $36,000, the amount of ordinary income which would have been realized had the contributed portion been sold ($60,000 fair market value less $24,000, Bob’s adjusted basis in the contributed portion of the property). Thus, the amount of Bob’s contribution will be $24,000.

F. Transfers of Partial Interests in Real Estate.

1. In general, a gift of less than a donor’s entire interest in property does not qualify as a charitable contribution under Section 170. Section 170(f)(3); Reg. §1.170A-7(a)(1). There is, however, an exception where the donor
contributes his or her entire undivided fractional interest to the charity. But, a taxpayer may not divide his property in such a way as to render his entire interest in the property a partial interest in order to circumvent the statute’s requirement. Reg. §1.170A-7(a)(2)(i). For example, a taxpayer who owns land in fee simple and who conveys a life estate to his son may not deduct the subsequent contribution of his remainder interest (his entire interest as of that point) to a charitable organization.

2. Certain exceptions exist to the rule stated above. A deduction is permitted for a contribution of a partial interest that is (1) an undivided portion of the donor’s entire interest, Section 170(f)(3)(B)(ii); Reg. §1.170A-7(b)(1), (2) an interest which would be deductible if made in trust, Section 170(f)(3)(A); Reg. §1.170A-7(b)(2), (3) a remainder interest in a personal residence or a farm, Section 170(f)(3)(B)(i); Reg. §1.170A-7(b)(3), (4), and (4) a qualified conservation interest, Section 170(f)(3)(B)(iii); Reg. §1.170A-7(b)(5). In addition, a deduction is allowed for contributions of partial interests that are made to more than one charitable organization if the aggregate contribution is of the taxpayer’s entire interest in the property. Reg. §1.170A-7(a)(2)(ii). For example, if a taxpayer transfers a life interest in property to one charitable organization and transfers the remainder interest to another charitable organization, the taxpayer will have made a charitable contribution equal to the fair market value of the entire property. Where a deduction for a charitable contribution of a partial interest is allowed, the value of the contribution is equal to the fair market value of the partial interest at the time of contribution. Reg. §1.170A-7(b)(1)(i). A contribution of an undivided portion of an entire interest in which the taxpayer retains an insubstantial right will still qualify as such because the IRS will treat it as if the taxpayer contributed the entire interest. See Priv. Ltr. Rul. 9729023 (April 17, 1997), where the IRS found that a contribution of an undivided portion of an entire interest in land by a taxpayer, who retained an easement to use the land’s driveway in order to get to his other property, qualified as a charitable contribution under §170 because the easement he retained was so insubstantial as to make the contribution in essence one of the entire interest. However, because the charity agreed to maintain the driveway, the taxpayer had to deduct the value of the maintenance from his charitable contribution deduction as consideration received. See also Rev. Rul. 75-66, 1975-1 CB 85, finding an easement to train a dog on contributed land was not substantial enough to affect the classification of the contribution.

3. Undivided Portions of Entire Interests. An undivided portion of a donor’s entire interest in property consists of a fraction or percentage of the donor’s interest, or each and every substantial interest or right owned by the donor in the property, and it must extend over the entire term of the donor’s interest in the property and in any other property into which the property is converted. Reg. §1.170A-7(b)(1)(i). A contribution of an
undivided portion of an entire interest in which the taxpayer retains an insubstantial right will still qualify as such because the IRS will treat it as if the taxpayer contributed the entire interest. See Priv. Ltr. Rul. 9729023 (April 17, 1997), where the IRS found that a contribution of an undivided portion of an entire interest in land by a taxpayer, who retained an easement to use the land’s driveway in order to get to his other property, qualified as a charitable contribution under §170 because the easement he retained was so insubstantial as to make the contribution in essence one of the entire interest. However, because the charity agreed to maintain the driveway, the taxpayer had to deduct the value of the maintenance from his charitable contribution deduction as consideration received. See also Rev. Rul. 75-66, 1975-1 CB 85, finding an easement to train a dog on contributed land was not substantial enough to affect the classification of the contribution.

a. Example 1. Ted owns 100 acres of land with a fair market value of $1 million and contributes one-half or 50 acres to a charitable organization. Since this represents an undivided portion of Ted’s entire interest in the property, Ted will be allowed a deduction of $500,000, the fair market value of one-half of the property.

b. Example 2. Same facts as Example 1, except that Ted instead contributes to the charitable organization an undivided one-half interest in the land, so that they will hold the property as tenants in common. If the present value of the property is $1 million, Ted will be entitled to a deduction of the present value of the contributed portion of the property or $500,000.

4. Interest Which Would Be Deductible in Trust. In general, the value of a partial interest which is transferred in trust is deductible as a charitable contribution only if the trust is a pooled income fund, a charitable remainder annuity trust or a charitable remainder unitrust. In addition, no deduction is allowed for an income interest in property which is a partial interest and which is contributed in trust unless the interest is either a guaranteed annuity interest or a unitrust interest, and the grantor is treated as the owner of such interest. The value of a contribution of a partial interest which would be deductible under Section 170(f)(2) if transferred in trust is also deductible if not contributed in trust.

a. Example 1. Ann places property in a charitable remainder unitrust, which provides for an income interest to Bill, an individual, and a remainder interest to Charity, a charitable organization. Ann may deduct the value of Charity’s interest.

b. Example 2. Same facts as above except that instead of placing the property in trust, Ann conveys a life estate to Bill and a remainder
interest to Charity. Ann may not deduct the value of Charity’s interest, because a remainder interest following a life estate could not have been transferred through a charitable remainder unitrust, a charitable remainder annuity trust or a pooled income fund.

5. Remainder Interests. A charitable contribution of an irrevocable remainder interest in a personal residence or a farm is deductible even if the contribution is not in trust, and the remainder interest is not the donor’s entire interest in the property. A “personal residence” must be property used as the donor’s personal residence, but need not be his principal residence. A “farm” must be property used by the donor or his tenant for the production of agricultural products or the sustenance of livestock. An inter vivos gift of a remainder interest in a personal residence or farm requires a reduction for depreciation on the portion of the property given (excluding land). In addition, it may be possible for the donor to retain an easement in gross over the underlying land upon which the residence sits when giving a remainder interest to the charity. As long as the residence is used for charitable purposes, the charity is considered to have the use of the underlying land as well. After the donor gives the remainder interest in the personal residence to charity, additions or improvements are also deductible as contributions for the use of the charitable remainderman.

a. Example 1. Dan contributes to a charitable organization a remainder interest in his vacation home, retaining a life estate for himself. Dan may claim a deduction equal to the present value of the remainder interest.

b. Example 2. Dan conveys a remainder interest in his personal residence as follows: 90 percent to Ed, an individual, and 10 percent to Charity, a charitable organization, as tenants in common. The transfer is subject to Dan’s retained life estate. Dan may claim a charitable contribution deduction with respect to the value of Charity’s interest. See Rev. Rul. 87-37, 1987-1 CB 295. This contribution is permitted, although a split interest between a charity and a noncharity is often disallowed where there is potential for the noncharity interest to act in such a way as to diminish or eliminate the charity’s interest.

G. Conservation Easements.

1. In General. Contributions of certain partial interests in, and certain rights attaching to, real property are deductible if they constitute “qualified conservation contributions.” Section 1206(a)(1) of the Pension Protection Act of 2006 added Section 170(b)(1)(E) to the Code to increase the percentage limitations and carryover period applicable to qualified conservation contributions made in taxable years beginning after
December 31, 2005, and before January 1, 2008. Under Section 170(b)(1)(E)(i), an individual may be allowed a deduction for any qualified conservation contribution to an organization described in Section 170(b)(1)(A) to the extent the aggregate of such contributions does not exceed the excess of 50 percent of the individual’s contribution base over the amount of all other charitable contributions allowed under Section 170(b)(1) (the 50 percent limitation). Thus, the 30 percent limitation applicable to contributions of capital gain property under Section 170(b)(1)(C) does not apply to qualified conservation contributions. If the aggregate amount of qualified conservation contributions exceeds the 50 percent limitation, Section 170(b)(1)(E)(ii) provides that the excess will be treated (consistent with Section 170(d)(1)) as a charitable contribution to which Section 170(b)(1)(E)(i) applies in each of the 15 succeeding years in order of time.

2. Rev. Proc. 2007-50 provides the following example:

“...in taxable year 2007 individual B, a calendar year taxpayer ... has a contribution base of $100. During 2007 B makes $60 of cash contributions to organizations described in §170(b)(1)(A) (that is, contributions to which the 50 percent limitation of §170(b)(1)(A) applies), and a qualified conservation contribution of capital gain property under §170(b)(1)(C)(iv) with a fair market value of $80. Assuming all other requirements of §170 are met, in 2007 B may deduct $50 of the cash contributions. The unused $10 of cash contributions is carried forward for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire $80 qualified conservation contribution deduction is carried forward for up to 15 years.” The 50 and 100 percent limitations in §170(b)(1)(E) apply only to qualified conservation contributions, defined in §170(h)(1) as a contribution of a qualified real property interest to a qualified organization, exclusively for conservation purposes. A qualified real property interest is defined in §170(h)(2) as any of the following interests: A) the entire interest of the taxpayer other than a qualified mineral interest; B) a remainder interest; and C) a restriction (granted in perpetuity) on the use which may be made of the real property.

3. There are separate rules for the treatment of conservation easements under the Pension Protection Act of 2006 for farmers and ranchers. Section 170(b)(1)(E)(iv) provides a special rule for a qualified conservation contribution taken into account by an individual who in the taxable year of the contribution is a qualified farmer or rancher, defined in §170(b)(1)(E)(v) as a taxpayer whose gross income from the trade or business of farming (within the meaning of §2032A(e)(5)) is greater than 50 percent of the taxpayer’s gross income for the taxable year. For such an individual, §170(b)(1)(E)(iv)(I) provides a general rule that the 50 percent limitation described above is increased to 100 percent (the 100 percent
limitation). However, for any contribution of property made after August 17, 2006, that is used or available for use in agriculture or livestock production, the 100 percent limitation applies only if the contribution is subject to a restriction that the property remain available for agriculture or livestock production. If the contribution is not subject to such a restriction, the 50 percent limitation applies. Section 170(b)(1)(E)(iv)(II) provides that the percentage limitations applicable to qualified conservation contributions taken into account by a qualified farmer or rancher are applied in the following order: First, contributions of property to which the 50 percent limitation applies are taken into account; then contributions of property to which the 100 percent limitation applies are taken into account. In the example above, if the individual were a qualified farmer or rancher, eligible for the 100 percent limitation in Section 170(b)(1)(E)(iv) in 2007, the Rev. Proc. explains that B may deduct $50 for the qualified conservation contribution in addition to the $50 deduction for cash contributions. As in A-1, the unused $10 of cash contributions is carried forward for up to 5 years. The unused $30 of the qualified conservation contribution is carried forward for up to 15 years. An individual is a qualified farmer or rancher if the individual's gross income from the trade or business of farming (as defined in §2032A(e)(5)) in the taxable year of the contribution is greater than 50 percent of the individual's total gross income for the taxable year of the contribution. Gross income includes all income from whatever source derived, except as otherwise provided, Section 61(a); §1.61-3. Gross income from the trade or business of farming is the gross income from activities described in §2032A(e)(5). Such activities include cultivating the soil; raising or harvesting any agricultural or horticultural commodity; raising, shearing, feeding, caring for, training, and management of animals; handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state but only if the owner, operator, or tenant of the farm regularly produces more than one-half of the commodity; and the planting, cultivating, caring for, or cutting of trees, or the preparation (other than milling) of trees for market. The Rev. Proc. makes clear that only an individual may be a qualified farmer or rancher.

4. A contribution is a “qualified conservation contribution” if (1) the interest contributed is a “qualified real property interest, (2) the contribution is made to a "qualified organization,” and (3) the contribution is made “exclusively for conservation purposes.”
Appendix A

Sample Carve Out in Loan Documents
for Estate Planning Related Transfers

; provided, however, that a change of Control shall not be deemed to have occurred under this subsection with respect to the transfer by an individual, by lifetime sale, gift, bequest at death under such individual’s last will and testament or any other means, and upon any terms dictated by such individual, all or any portion of his/her stock of Borrower to (A) a member of such individual’s Immediate Family (as defined below), (B) any trust the sole beneficiaries of which are the individual and/or members of the individual’s Immediate Family (as defined below), or (C) any entity the sole owners of which are the individual and/or members of the individual’s Immediate Family (as defined below), on the condition that one or more of the current owners of such stock shall retain at least fifty-one percent (51%) of the voting rights of Borrower at all times; provided further that, without prior consent of the Bank (i) the Borrower shall be expressly permitted to recapitalize the common stock of the Borrower into two classes of stock with the existing common stock converted into Class A voting stock and the creation of a new class of Class B non-voting stock, and (ii) the Borrower and its shareholders shall be permitted to cause the Borrower to issue a stock dividend or share exchange of Class A and Class B stock to the current holders of the common stock of the Borrower. As used herein, the term “Immediate Family” shall mean spouse, lineal descendant, father, mother, brother or sister of the transferring stockholder, including in-laws and adopted children.

Sample Permitted Transferee Language

A. Permitted Transfers. Notwithstanding the above, any Member (the “Transferring Member”) may transfer all or any portion of the Member’s Interest at any time to any of the following, hereinafter referred to as “Permitted Transferees”:

1. In the case of a trust that is a Member, to a sub-trust created under the terms of the trust that is the Transferring Member;

2. In the case of an individual Member, the children, other descendants of any such Member; or,

3. A trustee who holds such Membership Interest in trust for the exclusive benefit of any one or more of such persons listed in paragraph C.2. of this Article VII (a “Permitted Trust”).

4. A trustee of an inter vivos or testamentary trust for the lifetime benefit of a Member’s spouse, with the remainder being distributed, upon the death of the Member’s spouse (i) outright to the Member’s children or descendants or (ii) to a Permitted Trust.