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Estate Planning for Entrepreneurs

Mary Ann Mancini

Stefan F. Tucker
ESTATE PLANNING FOR ENTREPRENEURS

WILLIAM & MARY 2006 TAX CONFERENCE

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Mary Ann Mancini
Williams Mullen
Washington, D.C.

Stefan F. Tucker
Venable LLP
Washington, D.C.

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I. INTRODUCTION

A. Scope

This outline will provide a summary of the main features of estate planning techniques and considerations as they affect entrepreneurs in order to assist the practitioner who is not an estate planning attorney in recognizing estate planning opportunities for his or her client who is an entrepreneur. Consequently, this outline is not intended to provide an exhaustive analysis of Federal estate or gift taxation or estate planning. In addition, no attempt has been made to analyze any state or local gift, estate or inheritance taxes, although such taxes must also be considered as a factor affecting the advisability of any lifetime or testamentary transfer of real estate. Finally, this outline only addresses estate planning for citizens of the United States.

B. Overview and Goals of Estate Planning for Entrepreneurs

There are three basic goals of estate and gift tax planning for entrepreneurs: (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. While taxes cannot be ignored when planning for entrepreneurs, the additional goals, which can be as important as tax planning, include (1) creditor protection, (2) retention of control over the enterprise by the client, (3) management succession, and (4) economic support of the family.

II. FEDERAL ESTATE AND GIFT TAX HIGHLIGHTS

A. The Gift Tax

1. Essentially, the gift tax is an excise tax imposed on the transfer of property by gift during any calendar year; however, neither the Internal Revenue Code ("Code") nor the Regulations thereunder attempt to define the term "gift". The Regulations do state that the tax applies to "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed".

2. The tax applies to all transfers, whether direct or indirect, whether outright or in trust, and whether the property transferred is real or personal, tangible or intangible.

3. General Rules

   a. Generally, if the owner of real property wishes to make a lifetime gift of all or a portion of such property, the amount of the gift is the fair market value of the transferred property at the time of the gift; and the amount of tax due in connection with the gift
is calculated using the rate schedule set forth in Section 2001(c). For decedents dying before January 1, 2010, the maximum gift tax rates range from 35% to 49%, depending on the year in which the gift was made.⁵ After December 31, 2009, the maximum gift tax rate will be reduced to a maximum individual rate.⁶ For gifts over $500,000, the applicable rate after 2009 will be 35%.⁷

b. Gift tax rates are cumulative, which means that, as a donor makes gifts over the years that are subject to gift tax, the prior years’ gifts are added together with gifts made in the current year in order to determine the gift tax bracket for the current gifts.

c. If the gift is mortgaged real property, the amount of the gift is netted, so as to exclude the amount of the mortgage, even if the donor remains liable on the mortgage, so long as the mortgage is secured by the property and the donee does not have a right of subrogation against the donor. When a gift is so netted, then, as the donor makes subsequent payments on the mortgage, each such payment constitutes an additional gift.⁸

4. Exceptions

There are five exceptions to the requirement that transfers without consideration are subject to gift tax. Four of these are as follows:

a. Annual Exclusion

(1) The Federal gift tax law provides, under Section 2503(b), for an annual exclusion for gifts of $11,000 per donee. Accordingly, a donor may give any number of people up to $11,000 per year and pay no gift tax on the total amount given by the donor.

(2) This annual exclusion amount will be adjusted for inflation; however, in any year that the annual exclusion amount is not a multiple of $1,000, the amount will be rounded to the next lowest multiple of $1,000.⁹

(3) Under Section 2513(c), it is possible to treat a gift by husband and wife as being given one-half by each spouse, even though only one spouse is the owner of the gifted property. Therefore, one spouse can give $22,000 per donee each year, which will be treated as given one-half by each consenting spouse.¹⁰

(4) The annual exclusion provisions of Sections 2503 and 2513(c) apply only to gifts of present interests. Section 2503(b) specifically excludes gifts of future interests in property. A gift which does not provide the donee with an immediate benefit is not a present interest, and, therefore, it cannot be excluded under Section 2503. For purposes of Section 2503, the term “future interest” includes “reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time.”¹¹

b. Medical and Tuition Expense Exclusion
An exclusion from the gift tax is provided for any amounts paid as tuition or for medical care on behalf of any individual. Such amounts, if paid to an educational organization described in Section 170(b)(1)(A)(ii) or to any person who provides medical care will not be considered gifts for the purposes of gift tax, the unified credit or the annual exclusion from gift taxes.

The exclusion is available regardless of the relationship between the donor and donee.

c. Marital Deduction

Section 2523 allows for an unlimited marital deduction for qualifying gifts made to one's spouse, so long as such spouse is a citizen of the United States.

Qualifying gifts are outright gifts of property interests and certain gifts in trust or life estates, as described in Section 2523. Essentially, the donor will not receive a marital deduction for gifts other than outright gifts of property to his or her spouse unless the spouse has the use of the gifted property and its income for her or his lifetime and such use cannot be interfered with by any other person, including the donor.

There are essentially two types of marital trusts created during the donor’s lifetime that are eligible for the marital deduction. In order to be eligible, each type of trust must give the spouse all the income earned in such trust for the rest of the spouse’s life. In neither trust does the spouse have to be given access to the trust principal, although no one else can receive any principal while the spouse is living. Nor does the spouse have to be named a trustee of either trust. In one type of trust, the spouse must be given a general power of appointment over the trust in order for the trust to qualify for the marital deduction. In the other type of trust, the spouse does not have to be given this power of disposition over the trust; however, the donor must file a gift tax return and elect marital deduction qualification upon funding the trust. In both cases, to the extent the marital deduction was claimed to shield the gift from gift tax, the trusts will be included in the spouse’s taxable estate at his or her death.

d. Charitable Deduction

Section 2522 allows for an unlimited charitable deduction for qualifying gifts made to a public charity or private foundation.

Qualifying gifts are limited to outright gifts of the transferor’s interest in the gifted property, with the following exceptions:

(a) remainder interests in a farm or residence (despite the transferor’s retained life estate);

(b) irrevocable qualified easements in real property and
(c) remainder interests in qualified charitable remainder trusts, pooled income funds and charitable gift annuities.\textsuperscript{25/}

(3) When a donor makes a charitable gift, there is no longer any requirement that a gift tax return must be filed unless the donor is making a gift that falls within one of the exceptions described above (other than a gift of a qualified easement) or the transferor is making a gift of only a portion of the property or an interest in an entity.\textsuperscript{26/}

c. Gift Exemption

The fifth and final exception to the requirement that transfers without consideration are subject to gift and estate taxation is the unified credit. Section 2505 provides a unified tax credit\textsuperscript{27/} against the Federal gift tax liability.

(1) The exemption amount is currently $1,000,000. This exemption will not increase, even though under current law the estate and generation-skipping transfer tax exemption has increased from $1,000,000 to $1,500,000.

(2) This means that an individual may make taxable gifts (that is, gifts in excess of annual exclusion amounts) valued up to the current exemption amount in the aggregate before having to pay any gift tax.

B. Estate Tax

1. Under Section 2001, an estate tax is imposed on the value of the property held by a decedent at the time of his or her death. Under current law, the estate tax will be gradually phased out, and estates of decedents dying during 2010 will not be subject to any estate tax. In 2011, the estate tax system in place prior to current law will be reinstituted.

2. To calculate the estate tax, the decedent's taxable estate (which primarily includes all property owned at death less deductions for expenses of administering the decedent's estate, funeral expenses, debts, casualty losses, charitable gifts, marital bequests and state death taxes paid) is aggregated with all the taxable gifts made by the decedent after 1976.\textsuperscript{28/} A tentative estate tax is computed on that aggregate amount. Like the gift tax, the estate tax is a progressive tax. For decedents dying in calendar years after 2002 and before 2010, the minimum rate of tax is 18% for estates up to $10,000, and the maximum rate of tax imposed is in accordance with the following table:

<table>
<thead>
<tr>
<th>In calendar year:</th>
<th>The maximum rate is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>47 percent</td>
</tr>
<tr>
<td>2006</td>
<td>46 percent</td>
</tr>
<tr>
<td>2007, 2008, and 2009</td>
<td>45 percent</td>
</tr>
<tr>
<td>2010</td>
<td>Estate tax is repealed</td>
</tr>
<tr>
<td>2011</td>
<td>55 – 60 percent</td>
</tr>
</tbody>
</table>
3. Once the appropriate estate tax bracket is selected and a tentative tax is computed, the gift tax payable on the post-1976 taxable gifts is immediately subtracted from the total tax, and the resulting amount is the estate tax imposed on the estate. Against this estate tax, the applicable credit amount is applied to reduce the estate tax on a dollar-for-dollar basis.

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>Exclusion Amount</th>
<th>Credit Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$1,500,000</td>
<td>$555,800</td>
</tr>
<tr>
<td>2006, 2007 and 2008</td>
<td>$2,000,000</td>
<td>$780,000</td>
</tr>
<tr>
<td>2009</td>
<td>$3,500,000</td>
<td>$1,525,800</td>
</tr>
<tr>
<td>2010</td>
<td>Estate tax is repealed</td>
<td>Estate tax is repealed</td>
</tr>
<tr>
<td>2011</td>
<td>$1,000,000</td>
<td>$345,800</td>
</tr>
</tbody>
</table>

4. Thus, the amount sheltered from estate tax will rise from $1,500,000 in 2005 to $3,500,000 in 2009.

5. All Federal estate taxes are due within nine months of the decedent’s death. This rule presents two key areas of concern for the entrepreneur:

   a. how is such property to be valued for estate tax purposes;

   and

   b. will there be sufficient liquidity in the estate nine months after death to pay the estate taxes?

6. Marital Deduction

   a. As in the gift tax area, there is a marital deduction from the gross estate equal to the value of any interest in property which passes or has passed from the decedent to a surviving spouse who is a citizen of the United States, to the extent such interest is included in the decedent’s gross estate.

   b. The marital deduction allows the decedent to transfer real property to the surviving spouse without incurring any Federal estate tax liability on the transfer. However, if the decedent leaves everything to the surviving spouse, the surviving spouse will end up with the entire estate at his or her death, but with only his or her own exemption from estate taxes. Under this type of disposition, the first decedent spouse’s exemption has been lost.

7. Charitable Deduction

   a. As in the gift tax area, there is a charitable deduction from the gross estate equal to the value of any qualifying interest in property which passes or has passed from the decedent to a public charity or private foundation, to the extent such interest is included in the decedent’s gross estate.
b. Essentially, the same exceptions to the definition of qualifying interests that exist in the gift tax area also exist in the estate tax area.

C. The Generation-Skipping Transfer Tax ("GST")

The generation-skipping transfer tax is a flat tax, equal to the maximum Federal estate tax rate, that is in addition to the estate or gift tax and is imposed on transfers that, in effect, skip a generation. For example, if a grandparent makes a transfer to a grandchild or grandchild's trust that results in the property transferred by-passing a living child's estate, the grandparent has made a generation-skipping transfer. The theory behind this tax is that the government has lost revenue that it would have received as a result of the estate tax that would have been imposed had the property had been includable in the child's estate. GST is a substitute for the estate tax that is not imposed at the child's death. As with the estate tax, generation-skipping transfer tax is eliminated for transfers after December 31, 2009. However, after December 31, 2010, the generation-skipping tax is reinstituted.

1. The types of transfers that are considered generation-skipping transfers are as follows:
   a. Direct Skips
      
      (1) These are transfers to any person who has been assigned to (or to a trust in which all of the beneficiaries are persons) two or more generations below that of the transferor. These persons are known as "skip persons". The assignment of generations is applied as follows:

      (a) When the transferee is a lineal descendant of the transferor or the transferor's spouse, then the generations are based on the relationship to the transferor, regardless of how many years are between the generations. Therefore, a transfer to a grandchild of the transferor is always a direct skip and a transfer to a child of the transferor is never a direct skip.

      (b) When the transferee is not a lineal descendant of the transferor or the transferor's spouse, but is, instead, a collateral descendant (such as a grandniece or grandnephew) or is unrelated to the transferor, then:

         (i) a transferee who is not more than 12-1/2 years younger than the transferor is assigned to the transferor's generation;

         (ii) a transferee who is more than 12-1/2 years younger than the transferor but not more than 37-1/2 years younger is assigned to the first generation younger than the transferor; and

         (iii) similar rules apply to create new generations every 25 years.⁵¹/
b. Taxable Terminations

These are deemed transfers for GST purposes when (i) the interests of all the beneficiaries of the trust who are in the generation immediately succeeding the transferor’s terminate; (ii) the trust fund is not includable in the estates of any of such beneficiaries; and (iii) the only remaining beneficiaries of the trust are skip persons.

c. Taxable Distributions

Whenever there is a distribution from a trust to a skip person, and such distribution is not a direct skip or taxable termination, this transfer will be considered a generation-skipping transfer.

2. There are two exemptions from GST:

a. Section 2631 GST Exemption

(1) Every individual has an exemption against GST. For transfers after December 31, 2003 and before January 1, 2010, the GST exemption amount will equal the estate tax applicable exclusion amount under Section 2010(c). Thus, the GST exemption will be as follows:

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>GST Exemption Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>2006, 2007 and 2008</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2009</td>
<td>$3,500,000</td>
</tr>
<tr>
<td>2010</td>
<td>GST tax repealed</td>
</tr>
<tr>
<td>2011</td>
<td>$1,000,000 (plus post-1997 inflation adjustments)</td>
</tr>
</tbody>
</table>

(2) This exemption can be applied against a transfer immediately, if it is a direct skip. Moreover, the exemption amount can be allocated to transfers made to a trust which are not direct skips.

b. Predeceased Child Exemption

(1) If the transferee is a grandchild of transferor and, at the time a direct skip transfer is made, the parent of the grandchild, who is a lineal descendant of the transferor, is deceased, then the grandchild will, for purposes of GST, be considered the child of the transferor.

(2) If the transferor has no living lineal descendants at the time of the transfer and a transfer is made to a collateral relative whose parent is dead, then such transfers will also qualify for this exemption.
D. The State Estate and Gift Tax

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act"), and the resultant repeal of the federal estate tax, most States imposed a "pick-up" tax on a resident-decedent's estate which was equal to the Federal estate tax's maximum allowable credit for state death taxes. After the Federal estate tax was calculated on the federal estate tax return, the State received an amount equal to the state death tax credit and the amount paid to the State was a credit against the Federal estate tax. The Federal Government received the remainder of the estate tax, after such state death tax payment was subtracted.

The 2001 Act changed this. As of 2005, there is no longer a state death tax credit. Any death taxes imposed by a state will be treated as a deduction rather than a credit, which is not as valuable. In response to the elimination of the Federal state death tax credit, many states have enacted their own estate tax system, including a separate exemption from the state estate tax. The state-level exemptions are oftentimes not as generous as the federal exemptions. As a result, an estate may not have any federal estate tax due, but may have a state estate tax due upon the decedent's death.

For example, in Maryland, the state exemption from state estate tax is $1,000,000. Therefore, estates of $1,500,000 will have no federal estate tax but will have a Maryland estate tax on the excess over the Maryland exemption amount. The Maryland estate tax on the $500,000 in this example is approximately $70,000. On the other hand, Florida's estate tax exemption is tied to the Federal estate tax exemption and as the federal estate tax exemption rises, so does the Florida estate tax exemption.

State estate tax is imposed on all property of a resident-decedent other than real property located in another state. State estate tax is imposed on nonresident-decedents who own real property located in the subject state. As a result of this change, the residence or domicile of the decedent, for estate tax purposes, and the existence and location of real property has become very important.

It is possible to have a Florida decedent with real property located in Maryland for example and although there is no Florida estate tax, if the real property located in Maryland exceeds $1,000,000 in value, there were will estate tax payable to Maryland.

E. Basis Rules

1. General Basis Rules under Present Law

   a. Where property is acquired by purchase, the basis for such property is its cost.14

   b. Property which is acquired by gift generally has, under Section 1015(a), a basis in the hands of the donee equal to that of the donor.15
(1) If the basis of the property at the time of the gift was higher than its fair market value and the property is later sold by the donee, the basis for determining loss will be the fair market value at the time of the gift and the basis for determining gain will be the basis in the hands of the donor. As a consequence, the donee does not recognize gain or loss in that situation where he sells the property at a price between the donor's basis and the fair market value of the property at the time of the gift. If neither the donee nor the District Director of the Internal Revenue Service ("Service") is able to determine the basis of the property in the hands of the donor, the basis will be considered to be the fair market value of the property as of the date or the approximate date at which, according to the best information available, the property was acquired by the donor.

(2) Increase of Basis for Gift Tax Paid

The basis of gifted property is increased by the amount of gift tax paid with respect to the gift. Such increase, however, cannot exceed the gift tax attributable to the amount by which the fair market value of the property exceeds the adjusted basis of the property (the net appreciation of the property) as of the date of the gift.

c. The basis of property distributed from a trust or estate is computed as follows:

(1) Generally, the beneficiary receives property distributed from a trust or estate with the same basis of such property in the hands of the estate or trust immediately before distribution.

(2) Exceptions to the General Rule

(a) Section 643(e)(3) election. The fiduciary of the estate or trust may make an election under section 643(e) to treat the distribution as if the trust or estate had sold the property to the beneficiary at its fair market value and the beneficiary shall take the property with a basis equal to its fair market value. If a loss is recognized by the trust or estate, as a result of the deemed sale, the loss may be disallowed under the related party rules of section 267. However, if the beneficiary later sells the property at a gain, the beneficiary may reduce the gain by the amount of the disallowed loss.

(b) Distribution in satisfaction of a pecuniary bequest. This distribution will be treated as a sale of the property at its fair market value and the recipient will take the property with a fair market value basis. If the property is sold at a loss that is disallowed under section 267, the beneficiary will have the same basis adjustment as described above.

d. Under present law, the basis of property acquired by inheritance generally will, under Section 1014, be its fair market value (or its special use value if applicable) at the date of death or, if the alternate valuation date is used for Federal estate tax purposes, the fair market value at such date.
Exceptions to Stepped-up Basis at Death

(1) Income in respect of a decedent -- Property that is considered "income in respect of a decedent" will not receive a step-up in basis upon the death of the decedent under Section 1014. The term "income in respect of a decedent" is defined as those amounts to which a decedent was entitled as gross income, but which were not properly includable in computing the decedent's taxable income during his lifetime.

(2) To the extent that the value of land subject to a qualified conservation easement is excluded from estate taxes, the basis of such land will not be stepped-up, but instead the basis of such land will remain the same as in the hands of the decedent.

(3) Gifts of appreciated property within one year of death -- Where appreciated property was gifted to a decedent within one year of his or her death, and upon the decedent's death such property passes to the person who originally transferred it to the decedent, then, under Section 1014(e), the basis of such property will not be stepped-up under Section 1014(a). As a result, care should be taken when transferring property between spouses as gifts, if, upon the death of one spouse, the surviving spouse receives such property under the decedent's Will.

(4) When spouses hold property as joint tenants or tenants by the entirety, then, at the death of one spouse, one-half of the property is deemed owned by the decedent and included in the deceased spouse's estate, which thereby receives a step-up in basis. These types of property interests are referred to as "qualified joint interests." The remaining half retains its original basis. For those other than spouses, all of the jointly held property is included in the estate of the first joint owner to die, with a resultant step-up in basis for all of the property, except to the extent that the surviving joint owner can show that he or she contributed to the acquisition cost of the property.

(a) Increase of Basis for Decedent Spouse's Contribution in Pre-1977 Joint Tenancy. In Gallenstein v. United States, the Sixth Circuit carved out an exception to the general rules discussed above, which now exists in the Fourth, Ninth and Eleventh Circuits and in the Tax Court as well. Recently, the Service acquiesced to this position.

(b) Any jointly held property acquired by spouses prior to 1977 will be subject to the old rules of contribution rather than the deemed one-half rule because the rule for qualified joint interests did not apply to joint interests created before 1977. Under this reasoning, if practicable, it is now even more advantageous to show the decedent spouse contributed a disproportionately greater amount to the acquisition cost of the property. By doing so, a greater portion, if not all, of the property would receive a stepped-up basis in the property, and, as a result of the unlimited marital deduction, the property would pass to the surviving spouse, with its new stepped-up basis, free of any estate tax. This is, however, a two-edged sword. If the spouse who contributed little or nothing to the acquisition cost of property acquired before 1977 dies first, then the surviving spouse receives little or no step-up in basis.
e. Basis Adjustment under Section 754 for Partnership Interests

(1) The basis of a partnership interest held by an estate or any successor partner is generally determined by reference to the fair market value of the partnership interest on the date of death of the deceased partner, increased by the estate’s share of partnership liabilities on such date.54/

(2) In the absence of a pre-existing or timely Section 754 election by the partnership (or a distribution and election by the distributee partner under Section 732(d)), the death of a partner does not affect the inside basis of the assets held by the partnership at the time of the partner’s death. Accordingly, as a general rule, an estate or a decedent’s successor partner will have a stepped-up basis in the partnership interest owned by the decedent, while the basis of the partnership assets remains unchanged.

(3) However, if a partner dies and the partnership makes or already has in effect a Section 754 election, then the basis of the partnership’s assets will be adjusted with respect to the partnership interest of the deceased partner’s estate or successor partner to reflect the Federal estate tax value of the deceased partner’s interest in the partnership. Thus, for purposes of determining the estate or successor partner’s distributive shares of depreciation or gain or loss of the partnership for income tax purposes, the partnership uses this new basis for the partnership’s assets.56/

(4) As a result of the application of the foregoing rules, if a Section 754 election is not made by the partnership, the sale of an appreciated partnership asset by the partnership would require the partnership, and therefore the successor partner or the estate, to recognize gain on the sale, notwithstanding the stepped-up basis in the partnership interest owned by the successor partner or the estate. Thus, the absence of a Section 754 election by the partnership generally can cause tax disadvantages where a deceased partner’s estate or successor remains as a partner in the partnership because the basis in the partnership’s assets is not adjusted for purposes of computing gain or depreciation.57/

(5) Under Section 754, however, the basis will be stepped-down if the value of the property has dropped below its basis. A Section 754 election can therefore result in the inability to take a loss when such an asset is sold because of the stepped-down basis. A Section 754 election, once made, is applicable to all partners, not just the partner whose death prompted the election by the partnership.58/ Accordingly, the election must be carefully considered.

(6) On the other hand, even when there is no Section 754 election in effect, if a deceased partner’s interest is completely liquidated, the estate or successor partner generally takes a basis in the distributed assets equal to the basis in its partnership interest, resulting in a stepped-up basis in the distributed assets.59/

2. Basis Rules under Estate Tax Repeal Law

a. In 2010, under the 2001 Act, when the estate and generation-skipping tax is completely repealed, a "modified carryover basis" regime will be applied to
property acquired by bequest, devise or inheritance, or by the decedent's estate from the
decedent, property passing from the decedent to the extent such property passes without
consideration, and certain other property.69/

b. Recipients of property transferred at a decedent's death will receive
a "carryover basis."67/ This will be the lower of the adjusted basis of the decedent or the
property's fair market value on the date the decedent died.

c. The character of the property is also carried over.

d. Limited Basis Increase for Certain Property:

(1) Each estate would be allowed to increase the basis of assets
transferred up to a total of $1.3 million.68/

(a) This $1.3 million can be increased by the amount of unused capital
losses, net operating losses and certain "built-in" losses of the decedent.69/

(b) The basis of property transferred to a surviving spouse or to a
qualified terminable interest property trust can be increased by an additional $3 million.70/

(c) Nonresidents who are not U.S. citizens will be allowed to increase
the basis of property up to $60,000.70/

(d) The $1.3 million, $3 million and $60,000 amounts are each
adjusted annually for inflation occurring after December 31, 2010.71/

(2) An executor or administrator of a decedent's estate will
determine which assets will receive a step up and to what extent; and is empowered to allocate
basis asset-by-asset.72/ For instance, a personal representative can increase the basis of a single
share of stock or a block of stock. The basis cannot be increased above the asset's fair market
value.73/

(3) To obtain the limited basis increase, the property must both
be "owned by the decedent" and "acquired from the decedent."74/

(a) Property owned by the decedent.

(i) Generally, only property that is owned, or is treated as
owned, by the decedent at the time of the decedent's death is eligible for the basis increase.75/

(ii) Joint tenancy property held by spouses or property held
between spouses as tenants by the entireties can only receive a partial step-up – since one-half
of the property is treated having been owned by the decedent and thus only this portion is
considered owned by the decedent.76/

(iii) A different result occurs in the case of property held jointly
with a person other than the decedent's surviving spouse; or, possibly, with pre-1977 spousal

joint tenancies. In this case, the percentage of contribution test would be used. This means the portion of the property attributable to the decedent's contribution is treated as having been owned by the decedent.\(^7\)

(iv) If property was transferred by the decedent during his lifetime to a revocable trust that pays all of its income during the decedent's life to the decedent or at the direction of the decedent, the decedent is considered owner of that property for estate tax inclusion purposes.\(^7\)

(v) The decedent is not considered the owner of any property solely by reason of holding a power of appointment with respect to such property.\(^7\)

(b) Property acquired from the decedent is defined as:

(i) Property acquired by bequest, devise, or inheritance.

(ii) Property acquired by the decedent's estate from the decedent.

(iii) Property transferred by the decedent during his or her lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his or her death to revoke the trust.

(iv) Property transferred by the decedent during his or her lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his or her death to make any change to the enjoyment thereof through the exercise of a power to alter, amend or terminate the trust.

(v) Property passing from the decedent by reason of the decedent's death to the extent such property passed without consideration (e.g., property held as joint tenants with right of survivorship or as tenants by the entireties).

(vi) The surviving spouse's one-half share of certain community property held by the decedent and the surviving spouse as community property.

(4) No increase in basis is allowed for the following property:

(a) property that was acquired by the decedent by gift (other than from his or her spouse) during the three-year period ending on the date of the decedent's death;\(^7\)

(b) property that constitutes a right to receive income in respect of a decedent;\(^7\)

(c) stock or securities of a foreign personal holding company;\(^7\)

(d) stock of a domestic international sales corporation (or former domestic international sales corporation);\(^7\)
(e) stock of a foreign investment company, and

(f) stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election).

(5) Rules Implemented to Ameliorate the Consequences of Modified Basis:

(a) Transfers of property in satisfaction of a pecuniary bequest for estates of decedents dying after December 31, 2009. Gain or loss on the transfer of property in satisfaction of a pecuniary bequest is recognized to the estate only to the extent that the fair market value of the property at the time of the transfer exceeds the fair market value of the property on the date of the decedent's death (not the property's carryover basis).

(b) Transfer of property subject to a liability. Gain is not recognized at the time of death when the estate or heir (other than a tax-exempt beneficiary) acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property. Also no gain is recognized by the estate on the distribution of such property to a beneficiary (other than a tax-exempt beneficiary) of the estate because of the liability. A tax-exempt beneficiary is defined as the United States, a state, a possession, an organization that is exempt from income tax, any foreign person or entity and, to the extent provided in the regulations, any person to whom property is transferred for the principal purpose of tax avoidance.

(c) Income tax exclusion for the gain on the sale of a principal residence for estates of decedents dying after December 31, 2009. If the decedent's estate, an heir or a trust which, immediately before the death of the decedent was a qualified revocable trust as defined in section 645, sells the decedent's principal residence, $250,000 of gain can be excluded on the sale of the residence, if the decedent used the property as a principal residence for two or more years during the five-year period prior to the sale.

III. COMPARISON OF LIFETIME GIFTS TO TESTAMENTARY BEQUESTS

A. Comparison of Tax Consequences

1. Overriding consideration

Because the estate tax is scheduled to be repealed in 2010, lifetime gifts in excess of the applicable exemption amount should be carefully considered. The possibility that no transfer tax will be due upon a transferor’s death is a strong incentive to avoid paying transfer taxes during life.
2. Revaluation of Prior Taxable Gifts

a. Effective for gifts made after August 5, 1997, the Service is barred from revaluing gifts made in prior taxable periods for all purposes where a gift tax return has been filed, the three year statute of limitations has run, and the gifts have been adequately disclosed on the return.\footnote{66}

(1) Final Regulations on what is an adequate disclosure of gifts were issued on December 3, 1999.\footnote{86}

(a) Requirements of Adequate Disclosure.

In order to be considered to have provided adequate disclosure of a gift, the Service must be apprised of the nature of the gift and the taxpayer's basis for the reported value. This requirement can be satisfied by submitting one of two reports:

(i) a description of the property, any consideration received, the parties involved in the transfer, a detailed description of the method used to determine the fair market value of the transferred property including any financial data that was used and any discounts claimed in valuing the property must be set forth and a statement of any position taken that is contrary to any proposed, temporary or final Treasury regulation or revenue ruling published at the time of the transfer;\footnote{67} or

(ii) an appraisal prepared by a qualified appraiser that contains a description of the property, the appraisal process, the method of valuation used and any assumptions made.\footnote{68}

(b) If a Gift is Considered to be Adequately Disclosed.

The three-year statute of limitations starts to run, and upon the expiration of the statute, the Service must use the value of such gift for purposes of determining any subsequent gift or estate tax liability.\footnote{69}

(c) If a Gift is Not Considered to be Adequately Disclosed.

The value of the gift shall be the value as "finally determined" regardless of whether the gift tax is paid. Accordingly, the statute of limitations will not begin to run unless a return is filed or the matter is adjudicated or settled.

(d) Disclosure of Transfers Not Considered to be Gifts.

Transfers to members of the transferor's family (as defined in Section 2032A) that are made in the ordinary course of operating a business are deemed to be adequately disclosed if the transfers are properly reported by all parties for income tax purposes.\footnote{60}
(2) The donor now has an opportunity to resolve the valuation of a gift by petitioning the Tax Court for declaratory judgment relief as to the value of such gift, so long as (i) the value is in actual controversy with the Service and (ii) the petition is filed within 90 days of the Service’s Notice of Determination regarding the value of the gift.\textsuperscript{21/}

b. Upon the death of an individual, all of the taxable gifts the decedent made that utilized his or her unified credit are brought back into the estate at their values as of the dates of the gifts for purposes of determining the estate tax bracket to which the estate will be subject. Any subsequent appreciation in the value of the gifted property is not brought back into the estate. The amount of any unified credit is also restored to the estate to provide a full credit against the estate tax calculated at the higher bracket.

3. Three Year Rule for Gift Taxes Paid

Under Section 2035, if any gift tax is paid as the result of a lifetime gift, and the donor survives the payment of such gift tax by three years, the gift tax paid is removed from the estate. If, however, the donor does not so survive, then, for purposes of determining the decedent’s estate tax bracket, the gift tax is brought back into the estate along with the value of the gift determined as of the date of the gift and not at the date of the decedent’s death.

4. Removal of Appreciation from Estate

One of the most common reasons for making a lifetime gift of real property is to remove from the transferor’s estate tax base any further appreciation in the value of the gifted property. Thus, a gift effectively freezes the tax cost of transferring the property to the transferor’s intended beneficiary.

IV. NON-TAX REASONS FOR ENTITY OWNERSHIP

Entrepreneurs use entities such as Limited Partnerships or Family Limited Partnerships (“FLPs”) and Limited Liability Partnerships (“LLCs”) companies for several reasons, the most important of which are not tax related. These entities allow the owner to continue to control the management of the enterprise and establish a plan for the succession of that management, no matter who the limited partners or members may be, which is imperative, given the specialized nature of enterprise management. Furthermore, the entities protect the enterprise from creditor claims that are made against any of the entity’s owners or against any other enterprises the individual owns, which presumably are held in separate entities. Finally, these entities provide many non-tax estate planning benefits, such as probate avoidance.
A. Creditor Protection Provided by these Entities and the Creditor Remedies against Entity Owners

1. State Law Remedies

   a. Assignment of Partnership or LLC Interest to Creditor:

      If a creditor is able to force an owner to assign his or her interest in the entity to the creditor, the creditor could become a partner or member (and, if a general partner interest or Manager interest is so assigned, control the entity) unless the entity’s agreement provides otherwise. The agreement should provide that an assignee of a limited partner or member interest does not become a limited partner or member without the consent of a general partner or Manager and the assignee of a general partner or Manager interest does not become a limited partner or member without the consent of all (or some significant percentage in interest) of the partners. In all cases the agreement should prohibit any assignee from becoming a general partner or manager without the consent of all owners. A problem arises with the use of a corporate general partner in a limited partnership since the corporate general partner remains general partner, regardless of the financial circumstances of the owner of the shares of the corporate general partner. As a result, if the creditor forces the owner to assign his or her shares in the corporate general partner, the creditor will be able to control the partnership, and, for purposes of the partnership agreement, there has been no transfer that would prevent the creditor's admission to the partnership. If this is a possibility, the owner should consider giving up majority ownership of the corporate general partner and merely acting as president and a director of the corporation. Alternatively, a limited liability company should be considered, in order to hold the general partner interest. The owner would be irrevocably designated as the Manager and his or her ownership interest in the LLC would become irrelevant.

   b. Charging Orders:

      A charging order is the court-ordered remedy of a creditor if the creditor is unable to force a partner or member to assign his or her interest. A charging order is neither an assignment or an attachment. It is a court order that directs the entity to make any distributions to the owner’s creditors that it otherwise would have made to the owner. The theory behind the remedy is that, to allow a creditor access to the entity’s assets, records and, perhaps, management, as a result of the creditors’ claims against one owner, will disrupt the entity’s business to the detriment of the other owners. It is used in fairness to other (presumably unrelated) owners. It has been argued that this remedy is only appropriate in non-family situations; in family situations, where every partner or member is presumably aware of each other’s financial situation (and, indeed, the entity may have been formed in response to such situation), it is contended that the other owners are not entitled to the benefits of the creditor being able to secure only a charging order, so that creditors should be allowed to force the sale of the entity interest and/or reach the entity’s assets. As a court-ordered remedy, a charging order is strictly construed. If the creditor attempts to reach any interest other than what is provided in the order, he or she must obtain court approval. This remedy, therefore, results in greater legal expenses to the creditor than an assignment. As either an assignee or a holder of a charging order, the creditor may well be treated as a partner for income tax purposes; if no
distributions are forthcoming, he or she would nonetheless have to pay tax on income not received.

c. Power to Sell Interest:

Normally, a court will only impose a charging order. If, however, a creditor can establish that the claim may never be paid, a court may consider an order forcing the sale of the debtor's entity interest, although such an order is rare since a sale could cause a material adverse disruption to the entity. Even if such an order is obtained, the interest will have little value to an outside party, especially since the purchaser will merely become an assignee. Under most state Revised Uniform Limited Partnership Acts, a creditor cannot force the sale of a limited partner interest. In addition, under many limited liability company statutes, a charging order is the only remedy a creditor possesses. Nonetheless, since Federal bankruptcy law supersedes state law, it would be possible to obtain a Federal bankruptcy order to sell an entity interest, regardless of whether it is a general or limited partner interest, a member interest or a manager-member interest. In neither case, however, could a creditor force the sale of the underlying entity property, unless the claim was secured by such property.

In all events, the entity agreement should provide that the other owners and the entity should have the first right to purchase the interest, if it is to be sold.

d. Since LLCs are relatively new, the state law remedies for LLCs are not as certain.

2. Federal Bankruptcy Law:

Under Federal bankruptcy law, a bankruptcy trustee may attempt to withdraw from the partnership. Such an attempt should be addressed in the agreement by providing that the withdrawing partner or member (or his or her representative) does not receive fair value until the dissolution of the partnership. This must apply to any partner under any withdrawal in order to be supportable against a creditor.

3. Owner's Right to Receive "Fair Value" upon Withdrawal or Dissolution.

a. Notwithstanding the right of an owner to receive fair value upon liquidation, the ambiguity of the term "fair value" may well provide protection against creditors. For creditor purposes, unlike for purposes of Section 2704(b) (discussed below), the agreement determines what rights the owners have to withdraw and liquidate his or her interest, and, further, the value such owner will get for his or her interest upon withdrawal.

b. The valuation of the interest to which an owner is entitled is binding on creditors as well. As a result, the agreement should address two goals: (i) making the entity interest as unattractive as possible to a creditor by imposing a method of valuing the interest that will result in the lowest value possible, and (ii) establishing a value that the family can afford to pay when buying the owner out of the entity. Generally, the basis on which value can be determined is either "going concern" value, under which the entity is valued as a ongoing business with no disruptions, including the element of goodwill, or "liquidation" value, which is
the value the assets would bring if the owners were to sell all of the assets at one time for whatever they could obtain, without any element of goodwill. Obviously, valuing the interests by using the liquidation value method will result in a lower value. Furthermore, the agreement will either give the owner a pro rata percent of the entity assets, as valued either on a going concern or liquidation basis, or an amount after discounting the pro rata percent of the assets for the owner’s minority interest in the entity. Again, the second alternative will result in a lower value for both creditor attachment purposes (thereby forcing the creditor to look elsewhere for repayment) and family repurchase purposes.

c. The disadvantage of these valuation alternatives is that they cannot be used only for creditor protection purposes if they are to withstand court scrutiny. As a result, there may be reasons that a owner wants to withdraw that have nothing to do with financial issues, but the entity must (in the absence of new negotiations) pay the owner this lower value, thereby forcing the owner to remain in the entity so that he or she may recoup his or her investment.

4. Use of Separate Entities

The use of more than one entity to hold ownership interests should be considered for the following reasons:

a. Claims against an entity’s property (such as environmental claims) will only extend to the assets held in that entity, to the general partner’s assets (if it’s a partnership), or, if the general partner is a corporation or other entity, to such entity’s assets. Accordingly, if assets are held in different entities, the claims against one entity will not “taint” the assets in a separate entity. As a result of the general partner’s liability, consideration should be given to using a separate entity general partner for each partnership, since the entity general partner’s interest in the other partnerships could be reached because of the claims against one partnership’s assets.

b. Creating more than one entity and choosing different jurisdictions for each entity will make it much more difficult on the part of a creditor to reach all of the assets, so that the creditor may decide to attempt to reach the interests in the entities closest to the creditor or to seek to reach only certain entities, leaving the rest undisturbed.

c. There may be an adverse income tax consequence of creating more than one entity and holding different assets in different entities.2

B. Convert Real Property to Personalty

1. A partnership or LLC interest is personalty and, as a result, the situs of the entity may be established in any jurisdiction, including a foreign jurisdiction. Real property not held in an entity is probated in the place where it is located. However, personal property is subject to probate in the decedent’s domicile and may even avoid probate all together, if the personal property is converted into a non-probate asset, such as transferring it to a revocable trust or into joint ownership.
As personality, the ownership of the entity holding the real estate may, depending on state law, be subject to state estate tax in the descendant's state of residence and not in the state where the real estate is located.

2. Being able to change the situs of personal property can also have creditor and tax advantages, although it is recommended that there be some ties to the jurisdiction selected so that the choice of jurisdiction is not perceived as shopping for the most favorable situs for creditor, probate or tax purposes. As a result, it is possible to change the situs of real property by placing it into a partnership and moving the situs to a more favorable jurisdiction for probate (at least to the extent of moving the situs from the location of real estate to the decedent's domicile), state transfer tax and creditor purposes.

C. Other Estate Planning Benefits

1. Gifts of Real Property: giving undivided interests in real property is one of the simplest methods of transfers, however, although such gifts have the advantage of simplicity, there are far greater disadvantages. As a tenant in common, the donee's interest will be subject to his creditors, who will at the least have the right to compel the sale of that tenant in common interest, and may have the right to compel the sale of the entire property, in order to satisfy their claims. Another drawback to such gifts is that the property interest can be gifted or devised to any person, thereby leaving the remaining co-tenants with no control over their future co-owners. Finally, such interests will pass through probate upon each co-tenant's death with the resulting delay or other impediments in conveyancing.

2. A family can pool together its individual holdings especially when such holdings are interests in real estate. Once pooled together in a common ownership, the development and management of the various assets become much easier and more cost-efficient.

3. Entity arrangements allow families to negotiate with each other to determine a means of managing the property without intra-family litigation. If the family members are beyond negotiation, then the entity agreement allows the parents/older generation a means of imposing a system of management on future owners.

V. VALUATION ISSUES ARISING FROM ENTITY OWNERSHIP

A. Valuation of Real Estate

In order to plan effectively for lifetime or testamentary transfers of real property, it will be necessary to ascertain its value. Unfortunately, valuation of real estate is a highly specialized area, and valuation of the property may be difficult.

1. Fair Market Value: Highest and Best Use

   a. There is no statute specifically dealing with the valuation of real estate. The Regulations apply the fair market value approach. The Service interprets fair market value as the highest and best use of the property being valued on the valuation date. Thus, the value of a decedent’s real property is the amount that would be paid by a willing buyer
to a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts, and such value is generally based on the "highest and best use" to which the property could be put.  

b. The highest and best use of the property is not based on the use to which the property is actually put at the time of valuation in the estate, but on that use to which the property could be put in order to produce its greatest return or benefits. The value of the property may be reduced for the costs of cleaning environmentally contaminated property; however, a discount for speculative environmental concerns may not be permitted unless the taxpayer can demonstrate that a potential buyer would have perceived the condition of the property as an environmental problem as of the date of the decedent's death.  

c. Notwithstanding the foregoing, when property is sold within a reasonable time after death to disinterested third parties, the Service will ordinarily value the property at the sale price. However, if the later sale price reflects factors which were not present at the time of decedent's death, the sale price may not properly reflect the date of death value of the property. Conversely, if the person buying the property is a relative or a close friend, the sale price probably will not establish fair market value.  

d. The Service is likely to be persuaded by comparable sales or sales of similar property in the immediate neighborhood. However, obtaining comparables may be difficult since substantially identical buildings in large cities may vary greatly in value because of their specific locations or other factors, such as occupancy, the presence or absence of asbestos, availability of indoor parking and the like.  

e. Under Reg. §20.2031-(b), property is not to be valued at the value at which it is assessed for local tax purposes unless that value represents the fair market value as of the applicable valuation date. The effect of the assessed value of real property varies from jurisdiction to jurisdiction. In some areas, assessed value represents fair market value; in others, assessed value is not at all related to the fair market value of the property.  

f. Most often, in order to determine the highest and best use of the property, one of the three following general methods of appraisal is to be considered:  

(1) Comparable Sales Approach:  

The comparable sales approach is based on recent arms'-length sales of the same property or of properties which exhibit characteristics most similar to the property being sold. The comparability of property with other properties must focus on such factors as location, including proximity to schools, churches, transportation and amenities; financing terms; conditions of sales; configuration, topographic features and total area; restrictions on land use and zoning; road frontage and accessibility; available utilities and water rights; soil characteristics; mineral rights; riparian rights; and existing easements, covenants, rights of way, leases and other encumbrances in the land.
Capitalization of Rental Income:

Rental real estate can be valued by capitalizing rental income. Under this method, the average annual income which may be derived from the property is determined, and then such income is capitalized by dividing it over its holding period by a selected capitalization rate. In determining such income, full occupancy is assumed at the highest sustainable rental, but the normal vacancy rate is subtracted, and expenses are adjusted to eliminate nonrecurring and extraordinary items. Moreover, depreciation and interest are generally factored in, although the Service may take issue with the same. The capitalization of such income involves two components, one of which is the interest rate, or return on investment, and the second of which is the recapture rate, or return necessary to recover the investment. The interest rate component must include considerations of the current interest rates on riskless forms of investment (such as savings accounts, money market certificates and the like), the lack of liquidity in real estate and the probability of increases or decreases in the income stream from the property over a period of time. The recapture rate component is calculated in many respects like a bond repayment, in that there may be assumed: (1) a sinking fund method (annual payments, invested yearly at compound interest, producing repayment in full over the property’s estimated life), (2) a straight line method (level annual payments over the property’s estimated life), or (3) the annuity method (annual payments repaying principal, while paying an annual return on invested capital).

Cost of Reproduction or Replacement:

This method is used relatively infrequently. It is most common where the property is of a unique or special purpose or is of a new or experimental type of construction as to which no market truly exists. This method has been utilized to set an upper limit on valuation on the theory that a user would not pay more for the property than the cost of reproduction or replacement thereof. This method starts with the estimation of the replacement cost of the structure or improvements, generally by calculating the per square foot costs, and then subtracts depreciation and obsolescence therefrom. The discounted cash flow method is not generally used in the estate and gift tax area. This method looks at the value of the property by considering its cash flow and resale over its holding period and discounting to present value.

Dispute of Taxpayer’s Valuation by the Service

Particularly where assets are difficult to value, it is likely that the Service will dispute the value assigned to property for gift or estate tax purposes. If the Service does dispute such a value and makes its own determination thereof, the donor of the gift or the personal representative of the decedent’s estate may require the Service to show how its value was derived. The Service must furnish a written statement within 45 days of a written request therefor setting forth (1) the basis upon which its appraisal was determined, (2) any computation(s) made in such determination, and (3) a copy of any expert appraisal. The statement is for the purpose of providing full information to the parties involved, and it is not binding on the Service.
3. **Litigation of Value**

Courts adjudicating value will look at both parties’ appraisals and the methods used in the appraisals. The factors taken into consideration when reviewing the appraisals include the appraiser’s familiarity with the property and the appraiser’s qualifications. As a result, if a valuation dispute does reach litigation, it will often be resolved based on which appraiser is the most credible in his or her analysis.

4. **Undervaluation Penalties**

In addition to concern about whether the Service may dispute the taxpayer’s valuation, there is the possible exposure to penalties for undervaluing property for gift or estate tax purposes. The accuracy-related penalty rules of Section 6662 apply to estate and gift tax returns filed after December 31, 1989. The penalty is equal to 20% of any underpayment related to a substantial estate or gift tax valuation understatement if (i) the value of any property claimed on an estate or gift tax return is 50% or less of the amount determined to be correct and (ii) the amount of the underpayment exceeds $5,000. If the portion of the underpayment that is subject to this penalty is attributable to one or more gross valuation misstatements, the penalty increases to 40%. A gross valuation misstatement occurs if the asset value claimed on an estate or gift tax return is 25% or less of the value ultimately determined to be the correct value for such asset.

All property interests, not just real property, are subject to the penalty provisions of Section 6662. Nonetheless, taxpayers wishing to utilize real estate investments in their estate planning should not be unduly discouraged by problems of valuation and the potential penalty for incorrect valuation. The Service makes allowances for the fact that, in the gift and estate tax area, valuation problems are not uncommon. The penalty provisions are meant to target those who abuse the system by reporting unjustifiably low values.

B. **Discounts and Premium Adjustments to Valuation**

There are four primary discounts and two possible premiums that are imposed when valuing an asset (or an interest in an asset). Although these discounts are generally considered as one discount, they should be addressed separately.

1. **Minority Interest Discount**

This discount reflects the minority owner’s lack of control in the entity. As a result of the lack of control or voting power, the owner has no ability to influence the entity’s future (i.e., the management of the entity or the liquidation or merger of the entity) or the future of the owner’s investment (i.e., control the payment of dividends or make cash distributions).
2. **Lack of Marketability Discount**

This discount reflects the inability or limited ability of the owner to liquidate his or her investment, either because of timing restrictions or because the resultant liquidation value will not be fair market value. This discount, unless limited by the valuation rules of Chapter 14, as discussed below, should logically be available to all closely held business owners who are under restrictions on the disposition of their ownership interests, regardless of their percentage ownership in the entity.\(^{119/}\)

3. **Blockage Discount**

   a. This discount is based on the theory that, if the owner’s entire holding in the asset were to be placed on the market at once, the availability of so much of the asset will drive down the value of the asset. Although the Regulations state that this discount is available only in “exceptional cases”, in recent Tax Court Memoranda the Court concluded that blockage discounts ranging from 3.3% to 6.2% were appropriate.\(^{119/}\)

   b. Most recently, a blockage discount was allowed for unimproved real estate held in a land development company.\(^{120/}\) The Tax Court agreed that the properties could not be sold all at once without depressing the market and, hence, a blockage discount was appropriate.

4. **Built-in Gain Discount**

Recent cases in the Tax Court and the Second Circuit have held that a reduction in the value of gifted stock to reflect unrealized capital gains inherent in the underlying assets was appropriate.\(^{121/}\)

   a. In a case decided in the Sixth Circuit, involving two corporations holding real estate, the Court held that a discount for the built-in capital gains tax on the real estate was appropriate,\(^{122/}\) despite the Service and the Tax Court disallowing the discount in light of the corporation’s ability to defer the recognition of the gain indefinitely under Section 1031.

   b. The Tax Court recently held that the built-in gain discount would not be available in valuing interests in a partnership holding real estate, but did not dismiss such a discount for all partnerships.\(^{123/}\) The Court distinguished a C corporation, where the discount was allowed even though the corporation could convert to an S corporation and avoid recognition of gains on assets retained for ten years, from a partnership because the consequences of a decision so to convert and the ten year period made the avoidance of recognition problematical in a corporation. On the other hand, in the case of a partnership, in which a Section 754 election would avoid the recognition of gain immediately thereafter, there was no reason to expect that the partnership would not make such election. However, if the Section 754 election is not in effect and the taxpayer has no means by which to require the partnership to make the Section 754 election, the built-in gain discount may be available.\(^{124/}\)
5. Control Premium

   a. Instead of discounting the value of the gift (or the interest in the estate), it is possible that the interest in the entity will be valued at a premium to reflect the control the entity owner has over the entity. This type of premium will generally be imposed on the value of a partner’s general partner interest or the value of a majority shareholder’s stock in a closely held corporation. The Tax Court has held that such a premium will arise only when the entity owner has full and absolute control over the entity.125/

   b. In the past, the Tax Court imposed a premium on voting stock equal to 3% of the entire value of the company, not, as many appraisers have held, a percentage of the value of the voting shares themselves.126/ Although the decedent’s number of shares of voting stock was not large enough to give the decedent voting control, the Court held that a premium was appropriate because of the decedent’s voting privileges. This decision has been overturned.127/

6. Swing Vote Premium

   Another Service argument is that a minority interest, when combined with other ownership interests in the entity, may actually have enhanced value because such interest represents the “swing vote” as to the entity and its assets.128/

7. Basis for Discount in Value

   a. The discounts (and premiums) are imposed to reflect the true fair market value of an interest, in light of what a willing buyer and a willing seller would pay, when considering the restrictions imposed on such interest.

   b. Even if the donor owns 100% of the entity, a discount will be allowed in valuing gifted interests in the entity because the value of the gift, for gift tax purposes, is based on the interest transferred, rather than on what the donor held immediately prior to the gift.129/ For estate tax purposes, the value of the estate is based on what the decedent owned at the time of his or her death, rather than what the beneficiaries of the estate will receive.

   c. In fact, the Service has accepted the discounts in determining fair market value and used these discounts to reduce the value of property passing under the marital deduction. For purposes of deductions taken against income, gift, estate or generation skipping transfer taxes, the value of the property giving rise to the deduction is based on the interest transferred, rather than what the donor or decedent held either immediately prior to the gift or at the time of his or her death. For example, in one Letter Ruling, the decedent owned all of the stock, but only a minority interest passed under the marital bequest. The difference between 100% of the value of the stock includable in the taxable estate and the discounted value of the minority interest passing under the marital deduction was, to the extent it exceeded the decedent’s available unified credit, subject to estate taxes.130/
C. Exception to Valuation Adjustments for Purposes of Gift and Estate Tax

1. Certain Lapsing Rights under Section 2704(a). Section 2704(a) treats a lapse of voting or liquidation rights in certain family partnerships as a transfer of property for estate and gift tax purposes. The partnership must be one where the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the partnership.

   a. The value of the property being transferred will be equal to the difference in value of all of the individual's interest in the partnership before the lapse (determined as if the voting and liquidation rights were non-lapsing) and the value of such interests after the lapse.

   b. The donee of such transfer is not identified in the section, therefore making it very hard to claim a marital deduction, charitable deduction or even allocate generation-skipping transfer tax exemptions to the transfer.

2. Applicable Restrictions under Section 2704(b)

   a. Section 2704(b) may cause the value of any transferred interests to be based on the value of the entity without regard to any restrictions contained in the entity's agreement, depending on state law and the entity used. If stock in a corporation or an interest in a partnership or other entity is transferred to or for the benefit of a member of the transferor's family, and if, immediately before the transfer, the donor and the members of the donor's family controlled the entity and, after the transfer, the transferor's family can remove the restriction, then any "applicable restriction" will be disregarded in determining the value of the transferred interest.

   b. Under Section 2704(b)(1), an "applicable restriction" is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than under state law. If such a restriction exists, it is ignored for purposes of valuation and the state law restrictions are used to determine the value. In the past, the Service has held that any restriction in the entity agreements is ignored if more onerous than what state law provides. Recently, the Tax Court has restricted the application of Section 2704(b) to only those restrictions on liquidation rights. As a result, all other restrictions that are not restrictions on liquidation rights, even if more onerous than what is set forth under state law, can be considered for purposes of valuating the interests in the entity.

   (1) For example, the Service's position under many states' Revised Uniform Limited Partnership Acts is that any limited partner may withdraw from the partnership and receive "fair value" for his or her partnership interest unless a term of years for the partnership has been included in the agreement. As a result of this provision under the state statute, if the term of years included in the agreement is considered an "applicable restriction", the value of a gift of a limited partner interest must take into account, under Section 2704(b), the limited partner's right to withdraw upon six months' notice and receive fair value for his or her interest, regardless of the actual restrictions on the limited partner's ability to withdraw under the partnership agreement. The Tax Court has held that the right of withdrawal...
subject to a term of years is not a liquidation right so that particular provision granting these
rights upon withdrawal under state law may be ignored for purposes of Section 2704(b).123

(2) With respect to a limited liability company ("LLC"), if
state law provides that, upon the death of a member, in the absence of an operating agreement,
there must be unanimous consent by the remaining members to continue the limited liability
company, then the likelihood that the limited liability company will dissolve upon the death of
one of the members is very high. As a result, under the Tax Court’s holdings, despite any
provisions to the contrary in the operating agreement (such as the LLC will be continued upon
the consent of 51% of the members, thereby making dissolution upon the death of any one
member less likely), under such state law, since the likelihood that the members’ ability to
liquidate the entity and reach the limited liability company’s underlying property will be high,
the lack of marketability discount used to value the gift of such an interest for gift tax purposes
will be reduced pursuant to Section 2704(b) since the actual provisions of the agreement will be
ignored for purposes of valuation under this Section. The Fifth Circuit just opened the door for
more debate on this topic, however, reversing the Tax Court and rejecting the Service’s position
by holding that the only restrictions which are limited by Section 2704(b) are restrictions on the
ability to liquidate the entity.134

3. Certain Rights and Restrictions Disregarded under Section 2703

The Service has attacked valuation discounts at the audit level under
Section 2703 (discussed below in the context of buy-sell agreements) by attacking the
partnership (or LLC) agreement (in which are provided the restrictions that give rise to
discounts) as a device to transfer assets to family members for less than full and adequate
consideration. The Tax Court has rejected the Section 2703 argument, although the Service
continues to advance it.135

Buy-sell arrangements generally serve two purposes in the estate and gift
tax area -- they can reduce the value of the gift by placing restrictions on the property gifted to
the donor, and such arrangements, if structured properly, can fix the value of the asset for estate
tax purposes.

a. If assets either held in an estate or gifted are subject to an
agreement under which the rights of the owner are restricted, then, for gift tax purposes,
assuming that this type of agreement meets certain requirements, the restrictions can be taken
into account for purposes of valuing the gifted asset. For estate tax purposes, if the agreement
set out a formula to establish the price of the stock upon death and met other requirements, the
price established in the agreement could be determinative of the value of the asset.

b. Section 2703 controls the valuation of transferred assets subject to
rights or restrictions for gift and estate tax purposes. As a general rule, the value of property is
determined without regard to (i) any option, agreement or other right to acquire or use the
property at a price less than fair market value or (ii) any restriction on the right to sell or use the
property when family members own 50% or more of the entity.136 If certain requirements are
met, however, Section 2703 does not apply and the restrictions can be taken into account for
valuation purposes. To fall within the exception, the right or restriction must satisfy the following three requirements:

1. The right or restriction is a bona fide business arrangement;
2. The right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration; and
3. At the time the right or restriction is created, its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.137

These agreements afford the owner of the asset the advantage of certainty when planning for his or her estate tax burden and reduce the value of the asset for estate tax purposes through the choice of the pricing mechanism in the agreement and the restrictions imposed on the owner of the asset under the agreement.

d. Sec. 2703 has affected the goals of certainty in valuation by providing that any restrictions under such an agreement wherein family members own 50% or more of an entity are to be ignored for purposes of valuation (both for gift tax purposes and estate tax purposes).138 Such restrictions are defined, under Reg. §25.2703-1(a)(2), as any option, agreement or other right to acquire or use the property at a price less than the fair market value of the property and any restriction on the right to sell or use such property. The key exception to Sec. 2703 is, under Reg. §25.2703-1(b), an agreement that meets the following requirements:

1. It must be a bona fide business arrangement.
2. It cannot be a device to transfer property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth.139 For these purposes, factors taken into account are: the expected term of the agreement; the adequacy of consideration given in exchange for the rights granted; the current fair market value of the property; and anticipated changes in the value of the property during the term of the arrangement.140
3. The terms of the agreement must be comparable to similar arrangements entered into by persons in an arms'-length transaction. In order to establish similar arrangements and an arms'-length transaction, under Reg. §25.2703-1(b)(4)(ii), the following should be considered: (i) isolated comparables will not be sufficient; (ii) if two or more valuation methods are commonly used in a business, use of one method should not cause the valuation to fail; (iii) it should not be necessary that terms parallel any particular agreement; (iv) if a business is unique, comparables from similar businesses may be used; and (v) expert testimony likely will be required.

e. These types of agreements, even if they do not meet the requirements of Sec. 2703, are still binding on the parties and on the creditors of any of the parties and, therefore, are still effective for creditor protection purposes. Because the agreements are binding on the parties, the Service may include the asset in the owner’s estate at a
significantly higher value than that at which the entity or other owners may purchase the asset upon the owner’s death; the result of this may be that the estate will receive a price based on one value, while paying estate tax on a higher value. The proceeds of the sale may be insufficient to cover the tax liability, and an unusable capital loss carryforward may be created.141/

f. If a buy-sell agreement is binding on the parties but not on the Service and stock is sold at less than fair market value, such sale will be characterized as though an indirect transfer occurs with respect to the other owners. If one of those owners is the decedent’s spouse, the estate may obtain a marital deduction with respect to the spouse’s proportionate share.142/ If, however, the unanticipated excess value of the asset does not pass to a spouse, then it may absorb or exceed the deceased owner’s unified credit for estate tax purposes.

g. A buy-sell agreement is often used in the family context to ensure that, upon the death of a family member (or a divorce), the member’s ownership interest in the entity does not pass outside the family.

h. A buy-sell agreement may be used to provide the family with the ability to buy out any partner who has creditor claims; it can restrict the ability of any partner to transfer his or her interest, either during his or her lifetime or upon his or her death, outside of the family, even to a spouse; and, if the partner wishes to sell the partnership interest, it can provide a mechanism by which the family can buy the partner’s interest prior to it being offered outside of the family.

i. The purpose of maintaining family control and protecting against creditors should be considered a valid purpose for the buy-sell agreement for Federal estate and gift tax purposes.

D. Exception to Valuation Adjustments: Retention of Interest in Gifted Property

1. A gift can be a completed gift; but, if the donor has retained or holds at the time of his or her death control or enjoyment over the gifted asset, such control or enjoyment will bring the asset within the ambit of Sections 2036-2038,143/ in which case, despite the completion of the gift (and the possible payment of gift taxes), it is includable in the donor’s taxable estate (although any unified credit utilized at the time of the gift or any gift taxes paid will be credited against the estate tax that arises as a result of the inclusion of the gifted property in the donor’s estate).

a. If this occurs, the donor has lost the use of the funds (or assets) used to make the gift and pay the gift tax, if any, but has not achieved any of the benefits discussed above of making a gift, rather than a bequest, since the property is includable in the donor’s taxable estate upon his or her death.

b. Furthermore, if property is includable in the decedent’s taxable estate under Sections 2036, 2037 and/or 2038, it is not the value of the right or interest held by the decedent that is includable in the estate, but the value of the property (determined as of the
date of the decedent’s death, or alternative valuation date, as the case may be) over which such interest or power is held that is includable in the estate.\textsuperscript{144/}

c. The intent behind Sections 2036, 2037 and 2038 is that estate tax should be imposed on property that was given away by a decedent during his or her lifetime when the decedent:

(1) retained the economic benefit of the property (Sections 2036(a)(1) and 2036(b));

(2) made what is essentially a testamentary transfer because possession and enjoyment is deferred until the decedent’s death (Sections 2036(a)(2), 2037 and 2038); or

(3) reserved significant powers over the possession and enjoyment of the property (Sections 2036(a)(2) and 2038).

2. For a more complete discussion of Section 2036 as it relates to transfers of real property to family limited partnerships and limited liability companies, see Section VI.

VI. REDUCTION IN VALUATION THROUGH TRANSFERS TO ENTITIES

A. Outright Gifts of Split Interests in Real Property

1. Use of Discounts. Giving undivided interests in real property is one of the simplest methods of transfers. If the recipient receives less than a 50 percent interest, then the donor may be able to take minority interest and lack of marketability discounts on the value of the gift for gift tax purposes. However, in Letter Ruling 9336002, the Service limited such discounts to the estimated cost of partition.\textsuperscript{145/} The Tax Court, however, has been more generous than the Service.\textsuperscript{146/}

2. Disadvantages. Although such gifts have the advantage of simplicity, there are far greater disadvantages. As a tenant in common, the donee’s interest will be subject to his creditors, who will at the least have the right to compel the sale of that tenant in common interest, and may have the right to compel the sale of the entire property, in order to satisfy their claims. Another drawback to such gifts is that the property interest can be gifted or devised to any person, thereby leaving the remaining co-tenants with no control over their future co-owners. Finally, such interests will pass through probate upon each co-tenant’s death with the resulting delay or other impediments in conveyancing.

3. Risks. Another problem with outright gifts of partial interests in property is the possibility that the entire gift may be pulled back into the donor’s estate under Section 2036(a) as discussed above, providing for such inclusion if the donor has made a transfer but retains the possession or enjoyment of, or the right to receive income from, the property.\textsuperscript{147/}
B. Use of Family Limited Partnerships

The use of a family limited partnership is an extremely valuable tool in estate planning. It achieves several goals, not the least of which is obtaining discounts in value for lack of marketability and minority interests in light of the nature of a limited partner interest. Because the valuation discounts available in valuing partnership interests make family limited partnerships such an effective tool for transferring wealth, the Service has attacked such entities on multiple grounds. Care must be taken in drafting the operating agreement, selecting the owners of the partnership, choosing which assets the partnership will hold, and operating the partnership as a business or investment activity and not merely as a family bank account. A taxpayer wishing to create a family limited partnership must be aware of all the entity’s risks and restrictions before reaping its rewards.

1. Structuring the Family Limited Partnership

a. In structuring the family limited partnership, the general partners of such a partnership should be the younger generation family members, or, preferably, such members should hold the majority of the general partner interests, usually as proportionate owners of a limited liability company that would hold a one percent general partner interest in the family limited partnership.

b. The 99% limited partner interests would be allocated among the family members in proportion to each member’s contribution of assets to the partnership.

c. The size of a partnership is limited only by the amounts the younger family members (or their trusts) can afford to contribute, since it must match the limited partner interest they receive on a proportionate basis.

d. Another alternative is for the older members to make gifts of limited partner interests to the younger members. The gifts of the limited partner interests will be more deeply discounted, for gift tax purposes, than the discount the older members would receive for estate tax purposes. The reason for this is that not only would the gifts be discounted in recognition of the lack of marketability of the gifted limited partner interest, the gifts would be discounted because the older family members are giving away, to each younger family member, minority interests in the limited partnership.

e. If the discounted value of the minority limited partnership interests given from the older family member to the younger family member is less than the gift tax annual exclusion amount, then the older family members will be transferring the value of the underlying assets out of his or her estate to the younger family member free of transfer taxes. In addition, any subsequent appreciation on the underlying assets will also be removed from the donor’s estate.
2. The General Partner

a. When creating a Family Limited Partnership, the donor should, to limit his or her own personal liability, consider using a corporation or a limited liability company ("LLC") as general partner, rather than serving as general partner in his or her individual capacity.

b. By using an LLC as general partner, the only amount that will be at risk in the Family Limited Partnership with respect to issues that arise from and after that time will be the amount by which the Family Limited Partnership (including the corporate general partner) is funded and only to the extent the partnership (or entity general partner) is obligated; of course, all equity build-up in the Partnership is likewise at risk.

c. The donor may hold the interest in the corporate or LLC general partner individually or as tenants-by-the-entirety with his or her spouse.

d. Alternatively, the donor could give away all or a portion of his or her ownership in the corporate or LLC general partner so as not to retain control over the partnership. Retention of such control will result in a control premium being imposed on the value of the donor's interest in the partnership for estate tax purposes. Furthermore, such control may give the donor's creditors access to the underlying assets of the partnership, by giving such creditors the power to liquidate the partnership.

e. Under Section 2036(a)(2), if the donor transfers a limited partner interest and retains the right to designate persons who will possess or enjoy property or income therefrom (such as the donor's power, as general partner, to control the distribution of partnership income) and the power either does not end until the donor's death or is relinquished less than three years before the donor's death, the transferred property might be includable in the donor's estate. \(^{148}\)

(1) In order to avoid inclusion of the transferred interest in the donor's estate, it is advisable for the younger family members to own the general partner interest.

(2) If the donor is not willing to give up control of the partnership, the donor should at least give some limited partner interests to independent third parties\(^ {149}\) or a trustee who has absolute discretion over distributions.

f. Another benefit to holding the general partner interest through a corporation or LLC occurs at the death of the donor. Because the death of the general partner may be considered an event of termination of the Family Limited Partnership, holding the general partnership interest via a corporation or LLC ensures that no termination will occur upon the donor's death.

g. The bankruptcy of a general partner of a Family Limited Partnership may dissolve the Partnership unless a successor is designated under the agreement. If such a dissolution occurs, the underlying partnership property is at risk, inasmuch as the partner's share of such property will be subject to his or her (or its) creditors, and hence, vulnerable to a partition suit if the property is real estate.
3. Income Tax Consequences on Creation

a. To create a Family Limited Partnership, certain assets are transferred to the Limited Partnership in exchange for all of the general and limited partner interests. Generally, there will be no income tax consequences upon the initial transfer as the donor will simply be receiving "basis" in his or her partner interests equal to the basis of the property transferred into the Family Limited Partnership. Nonetheless, the transfer of the property to the entity may be subject to local transfer and recordation taxes.

b. If the donor transfers encumbered real estate into the Family Limited Partnership, the transfer may result in gain recognition by the donor because the donor will be deemed to have received a cash distribution to the extent of the liabilities from which the donor is considered relieved. This occurs because, if there are other partners in the partnership, the donor will be relieved of some portion of liability and will recognize gain to the extent that the amount from which the donor is relieved exceeds his or her basis in the property.

c. The following are some planning techniques designed to avoid the gain recognition that results when encumbered real estate is transferred to a Family Limited Partnership and, subsequently, limited partner interests are transferred to family members:

   (1) Have the donor personally guarantee the debt or indemnify the Partnership, to ensure there is no reduction in the donor’s liability upon the transfer.

   (2) Increase the donor’s basis prior to transferring the real estate to the Partnership.

   (3) Make capital improvements to the real estate.

   (4) Shift the debt security from the real estate that will be transferred to the Partnership to another parcel of real estate or other assets owned by the donor.

   (5) Reduce the amount of the debt prior to transferring the real estate to the Partnership.

d. Negative capital account.

   (1) If the donor transfers a direct or indirect interest in property in which he or she has a negative capital account (as a result of prior years’ depreciation deductions taken with respect to such property or a financing or refinancing in which dollars were placed in his or her pocket) to a Family Limited Partnership and subsequently transfers a limited partner interest to a family member, such a transfer may trigger the recognition of gain to the extent of the donor’s negative capital account, as a deemed distribution under Section 752(b).

   (2) If the donor transfers a limited partner interest to his or her spouse, gain may not be recognized under the provisions of Section 1041(a). If it is possible for the donor, as general partner, to retain his or her partnership liabilities while gifting (in the form of
limited partner interests) limited partner interests to family members, the provisions of Section 752(b) may not be triggered.

e. Section 704(e).

In forming a family limited partnership where capital is a material income-producing factor, one must be sure to comply with the provisions of Section 704(e). Specifically, (1) the donee partner must include the distributive share of the partnership in his or her taxable income, and (2) there must be an allowance for reasonable compensation for any services rendered to the partnership by the donor.

4. Estate Tax Consequences

a. A significant goal in forming a family limited partnership is the achievement of positive estate tax consequences, in the form of valuation discounts when calculating the donor’s gross estate.

b. Unfortunately, if the partnership is formed or administered incorrectly, the entire value of both the property interests transferred and those interests retained by the donor may be included in the donor’s gross estate, without the benefit of valuation discounts. The Service has attacked family limited partnerships both at the entity level and at the ownership level.

c. Lack of Business Purpose

(1) One common attack against the entity is that the partnership should be disregarded for lack of business purpose and economic substance. Where courts have found that no discernable purpose for a partnership exists other than to depress the value of the partnership assets in anticipation of death, the decedent’s transfer of assets to the partnership is deemed testamentary and is disregarded. As a result, no valuation discount is applied to the transferred assets.

(2) Some business purposes which should support most Family Limited Partnerships include the need for (a) centralized control; (b) orderly development and management of the partnership property; (c) facilitating; and (d) asset protection.

(3) Of course, the best way to prevent the partnership from being disregarded or to prevent partnership assets from being included in the donor’s estate is for the partnership actually to operate a business.

d. Retained Interest

In the early 2000s, the Service began successfully challenging Family Limited Partnerships at the ownership level on the basis of Section 2036(a). As of this writing, the government had only lost three cases on this issue. A challenge to Family Limited Partnerships under Section 2036(a) will be successful if it can be found that the decedent either (1) had possession or enjoyment of, or the right to the income from, the transferred property, or (2) had the right, either
alone or in conjunction with another, to designate the persons who shall possess or enjoy the property or the income therefrom.

(1) **Express or Implied Understanding**

(a) Most cases have centered around the finding of an "express or implied understanding" between the decedent and his or her family that partnership assets would be available to the decedent as needed.

(b) If such an agreement is found to exist, the decedent is deemed to have retained sufficient enjoyment of the transferred property to cause it to be included in his or her estate under Section 2036(a)(1).\(^1\)

(c) The finding of an implied agreement depends on the facts and circumstances at the time of or after the transfer. The cases the government won had some or all of the following "bad facts" in common:

(i) Decedent transferred almost all of his or her assets to the partnership.

(ii) Decedent continued to occupy transferred property without paying rent.

(iii) Decedent commingled partnership and personal assets.

(iv) Decedent distributed or used partnership assets in accordance with personal needs.

(v) Distributions were made to the limited partners on a non-pro rata basis, contrary to the terms of the partnership agreement.

(vi) Decedent transferred assets to the partnership in anticipation of his or her impending death.

(d) An example of a case in which an implied understanding was found, and one of the most widely cited family limited partnership cases, is Strangi v. Commissioner,\(^1\) which was recently upheld on appeal to the Fifth Circuit.

(i) In that case, the taxpayer (as represented under a power of attorney by his son-in-law) contributed about $10 million of assets, representing 98% of his total wealth, to a newly formed family limited partnership ("FLP") in exchange for a 99% limited partner interest. About 75% of the assets transferred to the FLP by the taxpayer were marketable securities or other liquid assets. The balance consisted of limited partnership interests and real estate, including the taxpayer's personal residence.
(ii) The taxpayer and his children created a corporation to serve as the 1% corporate general partner of the FLP. The taxpayer contributed just under $50,000 in exchange for a 47% interest, and his four children contributed just over $50,000 for an aggregate 53% interest in the company. A 0.25% stock interest in company was shortly thereafter given to a charity.

(iii) At the time of these transfers, the taxpayer was terminally ill. He died approximately two months after the transfers were completed. Prior to his death, the corporate general partner made two distributions from the FLP to the taxpayer “to meet his needs and expenses”. After the taxpayer’s death, his estate received distributions of over $3 million from the FLP to pay estate taxes, funeral and administration expenses.

(iv) Based on these facts, the Fifth Circuit concluded that the taxpayer and the other shareholders of the corporate general partner had an implicit agreement that allowed the taxpayer to retain the enjoyment of his property after the transfer to the FLP. In addition to the partnership’s distributions to the taxpayer to pay his expenses during life and at death, the taxpayer continued to live in his residence after it was transferred to the partnership, and payment of rent was deferred until after Strangi’s death.

(v) In Section 2036(a) cases, the taxpayer usually argues that such section should not apply because the transfers to the partnership were "bona fide sales for an adequate and full consideration". In addressing this exception to Section 2036, the Service conceded that the “full and adequate consideration” prong of the exception was met because the taxpayer received an interest in the partnership proportionate to the assets he transferred to it, and the partnership formalities were followed. The Fifth Circuit stated that, in order to pass the “bona fide sale” prong of the exception, there must be a substantial business or other non-tax purpose for contributing the assets to the partnership. The estate proffered five different non-tax rationales for the creation of the FLP, and both the Tax Court and the Fifth Circuit rejected each rationale as implausible. Therefore, the bona fide sale exception did not apply, and the full value of the $10 million in assets transferred to the FLP were included in the taxpayer’s estate.

(vi) Cases such as Strangi provide guidance as to what not to do when drafting, funding and administering a family limited partnership.

(2) Beneficial Enjoyment

(a) In two recent cases, the Service challenged family limited partnerships by arguing the decedent retained Section 2036(a)(2) control over the beneficial enjoyment of the assets transferred to the entity.

(b) Previously, taxpayers and the Service alike recognized that United States v. Byrum served as a protective shield against Section 2036(a)(2) claims. Despite the Service’s past acknowledgment of Byrum, the government successfully challenged transfers to family limited partnerships on Section 2036(a)(2) grounds in the lower court holdings in both Kimbell Sr. v. United States and Strangi v. Commissioner. On appeal to the Fifth Circuit, however, Kimbell was reversed, and, in
the Court was silent on the 2036(a)(2) argument, ruling that the assets transferred to the family limited partnership were included in the decedents' estates on 2036(a)(1) grounds. As a result of these Fifth Circuit decisions, no direct adverse authority exists for including assets transferred to a family limited partnership in a decedent's estate under Section 2036(a)(2). Nevertheless, taxpayers should still be cognizant of the Service's argument set forth in Kimbell and Strangi.

(d) In those cases, the Service argued that the taxpayer retained control over the general partner interest; therefore, the taxpayer had genuine control over the partnership actions, including the decision whether to distribute partnership earnings, and how much to distribute. Even where the taxpayer did not own a majority interest in the general partner, the Service argued that the taxpayer had influence over the other family members who owned the other interests.

(e) In Strangi, the Tax Court distinguished Byrum by arguing that the general partner in Strangi was not subject to the same economic and legal restraints with respect to distributions as was the majority shareholder in Byrum. In Strangi, the Court found there was no realistic way to enforce the general partner's fiduciary duties, as the taxpayer owned the 99% limited partner interest, nearly half of the general partner interest, and the other owners of the general partner interest were family members (with the exception of a charity that owned a de minimis interest in the general partner).

(f) To protect against inclusion of the partnership assets in the donor's estate, the donor should refrain from serving as general partner or controlling the partnership in any capacity. If the donor does not wish to give up control of the partnership, the following precautions should be considered:

(i) Fiduciary duties should be affirmed in the partnership agreement.

(ii) Partners should act consistently with the partnership agreement.

(iii) The distribution power of the manager or general partner should be limited to an ascertainable standard; for example, the partnership agreement could require that all net earnings (or at least enough to cover Federal, state and local income taxes, at an assumed aggregate rate) be distributed currently.

(iv) Other family members or unrelated persons could purchase limited partner interests. In the alternative, the donor could gift significant limited partner and/or general partner interests to family members or charitable organizations after creating the partnership.
5. Gift Tax Consequences

a. Annual Exclusion Gifts

As stated above, a donor may wish to make gifts of limited or general partner interests in a family limited partnership to children or other younger family members. Such gifts of limited partner interests are usually eligible for the annual per donee exclusion as gifts of present interests, despite the restrictions placed on the limited partners.\(^{169}\)

 Nonetheless, the Service has argued that the annual per donee exclusion does not apply where a partnership has negative cash flow and the donees receive no present economic benefit from the partnership.\(^{170}\)

As long as the donees are not restricted from receiving partnership distributions or selling their interests, either by the economic circumstances or the governing documents of the partnership, the annual per donee exclusion should be allowed.

b. Timing

The Service has commented (but not ruled) upon the issue of the timing of the subsequent gifts of limited partner interests. Where little or no time elapses between the transfer of property to a Family Limited Partnership and the gift of the limited partner interest, the Service may determine that the Family Limited Partnership does not have a purpose other than the reduction of estate and gift taxes, which is not considered by the Service to be a business purpose.\(^{171}\)

c. Gifts of Limited Partner Interests

When gifting the limited partner interests to family members, the donor has several alternatives.

(1) The first is to gift the interest to an individual in his or her sole name. As discussed below, if such individual has creditors who succeed in obtaining the limited partner's interest as an assignee, their rights in the Family Limited Partnership are less than the limited partner's rights. If it is desirable to restrict the individual's ability to transfer the interest (in order to keep it in the family), then it will be necessary to subject the limited partner interest to a buy-sell agreement.

(2) If the donee is a minor, it is possible under the Uniform Transfers to Minors Act statutes of most states to transfer the limited partner interest to a custodian who will hold the interest until the minor reaches the age of 18 or 21. Each state statute must be reviewed to ensure that a custodian is empowered under the statute to hold a limited partner interest. Under many of the older Uniform Gifts to Minors Act statutes, such an asset was not a permissible investment.

(3) The use of a trust to hold the limited partner interest is recommended when a buy-sell agreement is not possible and the donor wishes to restrict the donee's
ability to transfer the limited partner interest. If held in an irrevocable trust created by a person other than the beneficiary, the limited partner interest may be kept out of the donee’s ownership for creditor purposes (including a divorce situation) and out of the donee’s taxable estate. Furthermore, if the limited partner interest is held by a trust, then future unborn beneficiaries of the trust may participate in the Family Limited Partnership.

6. Drafting the Partnership Agreement.

In drafting the partnership agreement, the taxpayer should be mindful of how the estate and gift tax provisions are implicated by the following partnership characteristics.

a. If the donor/general partner takes a salary for managing the Family Limited Partnership, the salary should not be keyed to the actual income produced by the property and it should meet the standard for the industry and not be considered “disproportionate.”

b. Stock in a closely held corporation owned by the general partner which is transferred to the Family Limited Partnership clearly may cause a Section 2036(b) (retained voting rights) problem.

c. For nontax reasons, restrictions on transfers are usually imposed in Family Limited Partnership agreements, so this test should not create a problem. Such restrictions likewise should not be an issue under Section 2036 or 2038 so long as state law allows the transfer of a beneficial interest in the limited partner interest as an assignee, because the donor/general partner does not retain any power to alter the beneficial interest of the donee/limited partner.

d. It is not desirable that consent of all partners be required for continuation of the partnership, because the greater the limited partner’s ability to get to the underlying property, the smaller the size of the lack of marketability discount available when valuing the gifts of the limited partner interests.

e. Another issue in Family Limited Partnerships is the shift of income away from the limited partner under the terms of the partnership agreement. Although such income shifting is allowable within the confines of Section 704, an attempt to do so in a Family Limited Partnership context wherein the donor gifts limited partner interests and remains the general partner will run afoul of Section 2036(a). The Service has ruled that, if the donor retains the income of the limited partnership, the value of the entire partnership will be includable in the donor’s estate. In this situation, the donor had structured the partnership so as to pull out all of the income in the form of either salary or a disproportionate distributive share. The Tax Court has not agreed with the Service. The safest type of income allocation is a straight pro rata distribution of income based on percentage interests in the partnership, although, as previously noted, reasonable compensation for the general partner who or which manages the partnership property may be desirable—or even necessary.

f. The final “check-the-box” regulations allow taxpayers to elect, through a check-off system, income tax treatment as a partnership or an association taxable as a corporation. Thus, the conflict that once existed between the need to satisfy certain entity
characteristics in order to qualify for partnership status and the attendant risk of doing so for estate and gift tax purposes has largely disappeared.

C. Use of Limited Liability Companies

Under most state statutes, a limited liability company may have one or more members who are responsible for the management of the entity, similar to a general partner, and the remaining members have limited rights similar to limited partners. Limited liability companies generally have the same characteristics for income classification purposes that limited partnerships have—namely, restricted transferability and no continuity of life.

1. Disadvantages
   a. Lower discounts

   In many states, the limited liability company will have continuity of life in that the personal representative of the last remaining members may elect to continue the limited liability company.\(^{122}\)

   If the statute does not so provide, the limited liability company will dissolve in the event of the death, resignation, expulsion, bankruptcy or dissolution of any member unless all (or a majority) of the remaining members consent to continue the limited liability company. There is a much greater likelihood of this happening to any limited liability member than to the sole general partner of a family limited partnership. As a result in such instances, the discounts in gifts of interests as members in these entities may be less than gifts of limited partner interests since the possibility of the donee/members receiving the underlying property outright (as a result of the dissolution of the limited liability company) is greater.

   b. Lack of Precedent

   For many years, it was thought that a disadvantage to using a limited liability company was the lack of case law with regard to creditor rights against a debtor’s limited liability company interest. Now, however, such case law exists, so this is less of a concern.

2. Advantages
   a. A limited liability company is much easier to form than is a Family Limited Partnership.

   b. No member will be liable on the entity’s obligations, unlike a limited partnership wherein the general partner has liability. Even if the general partner is a limited liability company or an S corporation, the general partner-entity’s assets (which may be general partner interests in several limited partnerships) will be subject to these liabilities, even though there is no personal liability on the part of any partner.
Another advantage of a limited liability company is that its members can actively participate in the entity’s management, whereas the limited partners of a limited partnership risk exposure to liability if they become actively involved in the management of the limited partnership.

3. Valuation. Limited liability companies have the same valuation issues under Chapter 14 as family limited partnerships.

VII. REDUCTION IN VALUATION THROUGH RETAINED INTERESTS

A. Gifts of Trust Interests

1. General Rules

a. If real property (or an interest in real property) is placed into a trust for the benefit of one or more persons and the transferor does not retain any interest in the trust, the value of the gift will be the value of the property (or entity interest) passing to the Trust.

b. However, if the donor is a trust beneficiary who retains the right to the income of the trust for a term of years, then the special valuation rules for estate and gift tax purposes set forth in Section 2702 of the Code may apply.

c. Section 2702

The special valuation rules of Section 2702 state that, if the trust interest which is retained does not satisfy strict pay-out requirements defined in the Section, then such retained interest is not to be valued under the normal valuation rules of Section 7520 and the Regulations under Section 664, but, rather, is valued under the rules of Section 2702, the result of which is that the retained interest is valued at zero.\(^{178/}\)

Prior to the enactment of Section 2702, making such a transfer into trust and retaining a right in the trust income provided a means through which a donor could reduce the gift tax cost of transferring property to a donee.

(1) A reduction in the gift tax cost was achieved because, although the donor transferred the entire asset to the trust, as a result of the retained income interest the donor made a gift of only the remainder interest to the asset, so that only that interest would be subject to gift tax.

(2) The value of such remainder interest would be the value of the asset transferred to the trust, minus the value of the retained term interest, which was determined by reference to actuarial tables published by the Service. Thus, although the donee received the asset at the end of the stated term, including any appreciation on the asset that occurred after the date the trust was funded, the donor’s gift tax burden or charge against his or her unified credit was based on only a portion (the remainder interest) of the asset.
(3) In order for such a gift to succeed, the donor had to survive the retained term interest. If the donor died during the term, he or she was treated as having transferred the asset while retaining an income interest therein. This resulted in the full value of the asset being included in his or her estate under Section 2036(a).

(a) If there was inclusion in the estate and if any of the donor’s unified credit was used at the time of the creation of the trust, such amount of the unified credit would be restored to the grantor’s estate.

(b) If there was inclusion in the estate and any gift tax was paid, such tax would be credited against the estate tax payable, if any, as a result of the inclusion of the asset in the donor’s estate.

(4) There are several exceptions to the valuation rule of Section 2702. If the transaction fits within one of these exceptions, then the Service’s tables can be used to value the term interest, with such value subtracted from the value of the property for purposes of the gift tax determination. For example, an exception exists if the remainder interest of the trust is held by individuals other than the “members of the family” of the donor. The definition of “members of the family” includes, for purposes of this exception, the grantor’s spouse, any ancestor or lineal descendant of the grantor or the grantor’s spouse, any brother or sister of the grantor and the spouse of any such described individual.

B. GRATs and GRUTs

1. Grantor Retained Annuity Trusts and Grantor Retained Unitrusts are two types of trust with retained interests that are qualified interests under section 2702.

a. A Grantor Retained Annuity Trust (“GRAT”) and a Grantor Retained Unitrust (“GRUT”) are irrevocable trusts.

b. Each type of trust is established for a fixed term of years and the donor/grantor retains an income right. The income right in a GRAT or a GRUT is a stated amount paid to the donor/grantor each year during the term of the trust. Upon the termination of such trust, the trust fund, which would include any income earned during the trust term that exceeded the stated amount payable to the donor/grantor, is payable to the remainderman.

c. The difference between a GRAT and a GRUT is based on the determination of the stated amount paid to the donor/grantor, both of which fall within the definition of a qualified interest for purposes of section 2702.

(1) In a GRAT, the income interest is a fixed sum of dollars determined at the outset of the trust, which is payable each year.

(2) In a GRUT, the donor/grantor receives an amount equal to a fixed percentage of the fair market value of the trust. The percentage is fixed at the time the
GRUT is created; however, the fair market value of the GRUT, on which the percentage is based, is determined each year.

(3) It is possible to structure the payments under a GRAT to increase as the term continues, although the increase is limited to providing a lower payout at the beginning of the trust recognizes that certain property will not produce the same amount of income in early years as in later years.

d. Choosing a higher annuity will increase the present value of the donor/grantor's income interest to a point that the remainder interest (and hence the gift) is worth nothing. Prior to 2003, the Service took the position that GRATs could not be zeroed out, and the regulations dealing with GRATs and the new regulations dealing with the valuing annuities under §7250 also took this position. In Notice 2003-72, the Service acquiesced to the Tax Court's decision in Walton v. Commissioner, 115 TC 589 (2000), which allows taxpayers to create “zeroed out” GRATs.

e. A GRAT or GRUT will be considered a grantor trust for income tax purposes, so long as the annuity may be paid from income or principal, to the extent income is insufficient. As a result, (i) a GRAT or GRUT is an eligible S corporation shareholder; (ii) all the income is includable in the grantor’s taxable income, whether or not it is paid to him or her; and (iii) any deductible expenses will be deductible by the grantor.

Example
60 year old Donor
Section 7520 is 3.6%
Value of asset is $1,000,000
Annual Payout

<table>
<thead>
<tr>
<th>Annuity Amount</th>
<th>Value of Gift</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>10 year GRAT</strong></td>
<td></td>
</tr>
<tr>
<td>a. $50,000</td>
<td>$586,260</td>
</tr>
<tr>
<td>b. $90,000</td>
<td>$255,268</td>
</tr>
<tr>
<td>c. $120,848</td>
<td>-0-</td>
</tr>
<tr>
<td><strong>8 year GRAT</strong></td>
<td></td>
</tr>
<tr>
<td>a. $50,000</td>
<td>$657,730</td>
</tr>
<tr>
<td>b. $90,000</td>
<td>$383,914</td>
</tr>
<tr>
<td>c. $146,083</td>
<td>-0-</td>
</tr>
<tr>
<td><strong>2 year GRAT</strong></td>
<td></td>
</tr>
<tr>
<td>a. $527,148</td>
<td>-0-</td>
</tr>
</tbody>
</table>
10 year GRUT

a. 5%  $632,410
b. 9%  $435,400

8 year GRUT

a. 5%  $687,060
b. 9%  $504,320

f. There are several exceptions to the valuation rule of section 2702. If the transaction fits within one of these exceptions, then the Service’s tables can be used to value the term interest, even if the donor/grantor retained all of the income for a period of years rather than an annuity or unitrust interest. This value would be subtracted from the value of the property for purposes of the gift tax determination.

C. PRTs and QPRTs

1. Personal Residence Trusts -- Another exception relates to a trust which holds the personal residence of the holder of the term interest, under section 2702(a)(3)(A)(ii).

a. The term “personal residence” is defined by the Regulations to be either a residence within the meaning of section 1034 of the Code or one other residence, usually a vacation home, as defined in section 280A(d)(1) (but without regard to section 280A(d)(2)), or a fractional undivided interest in either. The personal residence can also include appurtenant structures and adjacent land used by the term holder for residential purposes and reasonably appropriate for residential purposes.

b. The term holder, as donor, is limited in the number of personal residence trusts he or she can create. The Regulations state that, if such term holder/grantor already holds term interests in two trusts that are personal residence trusts of which the term holder was the grantor, a third trust will not qualify as a personal residence trust.

c. A personal residence trust qualifies for the exception from the section 2702(a) valuation rules only if the trust agreement prohibits the trust from holding any asset other than the personal residence of the term holder and “qualified proceeds”.

d. Qualified proceeds are defined in the Regulations as proceeds payable as a result of damage to or destruction or involuntary conversion of the residence. These qualified proceeds must, however, be reinvested in a personal residence of the term holder within two years from the date the proceeds are received. If the residence is sold or otherwise transferred by the trust, the personal residence trust must terminate.

2. Qualified Personal Residence Trusts -- The Regulations provide a safe harbor in the form of a more flexible personal residence trust called a Qualified Personal Residence Trust (“QPRT”).
a. Under Reg §25.2702-5(1)(9), the trust agreement must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse at any time during the original retained trust term. In addition, it prohibits such sale or transfer at any time after the original term interest during which the trust is a grantor trust.

b. Under Reg §25.2702-5(c)(5), the QPRT is permitted to hold other assets, in addition to the personal residence and qualified proceeds, for limited periods of time, and still be eligible for the exception from the section 2702(a) valuation rules.

c. The trust agreement must include language that directs the income of the trust to be distributed to the term holder at least annually, and that assures that principal cannot be distributed to anyone other than the term holder prior to the expiration of the retained term interest.

d. The trust agreement must prohibit the commutation (prepayment) of the term holder’s interest.

e. Under Reg §25.2702-5(c)(5), a QPRT is prohibited from holding any assets other than the personal residence, improvements thereupon, qualified proceeds, policies of insurance on the residence and certain cash additions.

(1) Such cash additions can be made only for the following purposes:

(a) the payment of trust expenses that have been incurred or are reasonably be expected to be incurred within six months of the date the cash addition was made;

(b) improvements to the residence to be paid within six months of the date the cash addition was made;

(c) the purchase of the personal residence within three months of the date the trust is created (the trustee must have entered into a contract to purchase the personal residence prior to such cash addition); and

(d) the replacement of the personal residence with another personal residence (as long as the trustee has entered into a contract to purchase prior to the date the cash addition is made).

(2) The trustee must be required to determine each quarter whether the amounts held in the trust exceed the amounts required for the purposes described above. If the trustee so determines, the excess cash must be distributed to the term holder immediately thereafter.

f. If the QPRT ceases to qualify as such prior to the end of the term holder’s interest, the trust agreement must provide that, within 30 days of such cessation, either
the assets must be distributed to the term holder or the trust must be converted to a “qualified annuity” for the remainder of the term holder’s interest. The annuity factor will, under Reg §25.2702-5(c)(8)(C)(2), be determined at the rate used in valuing the retained interest at the time of the original transfer, rather than the time the trust ceased to be a QPRT.

g. If the residence is sold (the Grantor and the Grantor’s spouse cannot buy back the residence), then, unlike the personal residence trust, which would terminate immediately, the QPRT is allowed to hold the sale proceeds until the earlier of:

(1) two years from the date of sale;

(2) the termination of the term holder’s interest in the trust; or

(3) that date on which a new residence is acquired by the trust.

Example

A donor places a residence worth $1,000,000 into a Personal Residence Trust at a time when the section 7520 rate is 3.6%:

<table>
<thead>
<tr>
<th>Terms of the Trust</th>
<th>Value of Gift</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. If the donor is 75 years old and retains the right to use the residence for 3 years:</td>
<td>$784,110</td>
</tr>
<tr>
<td>B. If the donor is 75 years old and retains the right to use the residence for 5 years:</td>
<td>$652,660</td>
</tr>
<tr>
<td>C. If the 75 year old donor is married to a 65 year old spouse and the residence is divided in half, with each spouse owning one-half:</td>
<td></td>
</tr>
<tr>
<td>1. 75 year old donor transfers his one-half interest in the house to the trust at a value of $450,000 ($500,000 discounted for estimated cost of partition [10%]) and retains the right to use his half for 5 years:</td>
<td>$293,696</td>
</tr>
<tr>
<td>2. 65 year old donor transfers her one-half interest in the house to the trust at a value of $450,000 ($500,000 discounted for estimated cost of partition [10%]) and retains the right to use her half for 15 years:</td>
<td>$156,752</td>
</tr>
<tr>
<td>Total gift for gift tax purposes</td>
<td>$450,448</td>
</tr>
</tbody>
</table>
Revenue Procedure 2003-42 provides a sample declaration of trust for a QPRT. The Service will recognize a trust as a QPRT meeting all the requirements of Section 2702(a)(3)(A) and Regulation § 25.2702-5(c) first, if the trust instrument is substantially similar to the sample in the revenue procedure; and, second, if the trust operates in a manner consistent with the terms of the trust instrument.

VIII. FREEZING VALUES FOR ESTATE TAX PURPOSES

A. Intrafamily Sales of Property

The primary goal (and hence advantage) of the intrafamily sale is that such a sale "freezes" the value of the asset being sold at its then value, and removes future appreciation in such asset from the seller's estate. In the absence of some disqualifying factor, there is no gift or estate tax on the post-sale appreciation. There may well be income tax payable by the seller; nonetheless, assuming long-term capital gains treatment, the income tax rate will not be greater than 28 percent, whereas the estate tax rate, which would be applied against the property itself as well as those dollars which would have been used to pay the income tax, may be as high as 45 to 49 percent.

1. Assuming that the sale is made at current value, there should be no gift element, or gift tax payable, with respect to the transaction. Furthermore, the discounts discussed above for gift tax purposes, are discounts that recognize the true fair market value of the property that is gifted. Therefore, the same discounts would be applicable when determining the sale price of the asset since the sale amount should be equal to the true fair market value of the property that is being sold to the buyer.

2. The purchaser's basis in the purchased property will be the amount paid to acquire the same. This may be significantly less than the value of the property at the time of the seller's death (which would become the property’s basis if the recipient received the property from the seller’s estate). However, one must not overstate the benefit of this basis adjustment on death inasmuch as this appreciation can be taxed at rates up to 45 to 49 percent if included in the seller's estate, as compared with 28 percent if and when the property is sold by the purchaser.

3. An intrafamily sale may have the added advantage of providing needed liquidity to the seller. Consider the situation where an older generation taxpayer has been acquiring real property throughout his or her lifetime, always anticipating that the income generated by such property would provide sufficient income throughout such person's "retirement". Due to the general state of the economy, the real property cannot generate the once anticipated income. This situation is further complicated because there is no market for the property. Assuming that future appreciation is anticipated (once the economy turns around), then, through selling the property to one's family members, the seller benefits by receiving cash to live on, and the purchaser benefits because the property may be purchased at a price which, it is anticipated, is less than the expected future value of the property.

4. Further, and importantly, on the non-tax side, an intrafamily sale offers the opportunity to retain the asset in one’s family.
5. Finally, a sale transaction allows the family to move assets to younger generations even when the gift tax, if a gift of the same asset had been made, would have been prohibitive, or, in the case of transfers to grandchildren, the generation skipping transfer tax exemption has been fully utilized and any further gifts to would incur not only a gift tax but a generation skipping transfer tax as well.

6. Note Freeze

   a. A donor may sell the fee interest in the real property to a donee in exchange for notes from the donee that have a value equal to the excess of the value of the transferred property over the amount of the allowable annual exclusion for the current year. In successive years, the donor may forgive an amount of the notes equal to the annual exclusion, so long as there is no pre-existing agreement to do so, as discussed immediately below. Of course, the forgiveness of the notes may trigger recognition of gain by the donor under the installment sales rules. The value of the balance of the note as of the decedent’s date of death will be includable in the donor’s estate under Section 2031.

   b. The amount of a gift is the value of the property transferred reduced by the value of notes or consideration received in exchange by the donor. For income tax purposes, the transfer of property in exchange for a note would be treated as a sale to the extent of the consideration received.

   c. A promissory note given to the transferor by the donee may not be recognized by the Service as consideration if it is systematically forgiven in annual increments equal to the annual gift tax exclusion. The Service may argue that the notes must be disregarded ab initio, so that the transfer is treated when made as a gift of the entire value of the property. That result must follow, according to the Service, if the transferor intended from the outset to forgive the notes that he or she received.

   (1) The issue has been most frequently litigated in the Tax Court, which has generally recognized valid, enforceable notes as consideration, particularly when they were secured.

   (2) The Service did succeed in Deal v. Commissioner, where the Court found that the notes executed by the transferee daughters “were not intended to be enforced and were not intended as consideration for the transfer by the petitioner, and that, in substance, the transfer of the property was by gift.”

7. Installment Sales

   a. The fact that younger generation family members do not have currently available resources to purchase an asset from an older generation family member need not preclude using an intrafamily sale for estate planning purposes. The installment sale is a device through which an individual may effectively accomplish the estate planning goals described in the general discussion about intrafamily gifts.
b. An installment sale to family members is attractive for the same reasons as is an installment sale to an outsider, in that, generally, unless the seller elects not to use the installment method of reporting, any gain on the sale is deferred and taxed ratably as payments are received (or the purchaser's notes are cancelled). When property is sold for full and adequate consideration, only the value of the installment obligation is includable in the seller's estate. Thus, as a general rule, as with any outright sale, the installment sale enables a person to remove future asset appreciation from his or her estate.

c. In general, the installment method of reporting gain on the sale of property applies whenever a payment will be received in a year other than the year of disposition. Under the installment method, the gain recognized for a tax year is "that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price." Gain or loss is usually recognized whenever the holder sells, exchanges or otherwise disposes of the installment obligation.

d. Upon the decedent's death, his or her estate includes only what remains of the sales proceeds and/or the outstanding installment obligation. This amount, however, is considered income in respect of a decedent, and the estate does not receive a step-up in its basis in the note. Accordingly, any future payments are taxable income to the estate or its beneficiaries, depending on who receives the payments. If the note is cancelled or distributed to its obligor, such a distribution is treated as a disposition under the installment sale rules and all gain will be immediately recognized by the estate.

e. For estate tax purposes, the value of an outstanding installment obligation may be discounted if it carries a below-market rate of interest, or there is an extended period of time to maturity. On the other hand, if the transferor received less than full and adequate consideration upon the sale of the property when the note was executed, then the full date of death value of the property may be includable in the transferor's estate under Sections 2036 through 2038. The Service could find that the seller gave away a portion of property and, under the terms of the note payments or security interests, retained an interest in the property sufficient to make these Sections applicable. Therefore, in designing any installment sale for estate planning purposes, the transferor must be careful not to retain any interest which may require inclusion under these Sections inasmuch as there is always a possibility that the consideration may be found not to equal the value of the property.

8. Self-Cancelling Installment Notes

a. General Rule

(1) If property is sold and an installment note is taken back by the seller, neither the value of the transferred property nor the balance of the note will be includable in the seller's estate for estate tax purposes where the installment obligation automatically terminates upon the death of the seller, so long as the sale is bona fide and for full and adequate consideration and the provision for termination was bargained for by the parties.
(2) A "self-cancelling installment note" is a debt obligation which, by its terms, will be extinguished, with the remaining note balance thereof automatically cancelled, in the event of the death of the seller/creditor. To compensate the seller for this risk of cancellation, the terms of the note must reflect a "risk premium", either in the form of an increased purchase price or an increased interest rate on the note.

(3) Thus, a self-cancelling installment note that terminates by reason of the decedent/noteholder’s death not only freezes the estate tax value of the property being sold, but also removes a portion of that value from the seller’s estate in the situation where the seller dies before the note is paid in full, thereby adding another substantial estate planning benefit to using an intrafamily installment sale.

b. Income Tax Consequences to the Seller

In Estate of Frane v. Commissioner, the Court addressed the income tax treatment of self-canceling installment notes. The decedent had sold stock in a family business to his children in return for self-canceling installment notes and reported gain on the installment method. At decedent’s death, the installment notes were cancelled. The Court held that the unreported gain on the sale was reportable on the decedent’s final income tax return; however, the Eighth Circuit held that the unreported gain is reportable on the estate’s income tax return.

c. Income Tax Consequences to the Buyer

(1) While the noteholder is alive, the self-canceling installment note is treated the same as any other installment obligation and the note is subject to the rules of Section 453, as well as Sections 483, 1274 and 1274A.

(2) Upon the death of the noteholder, the Court held in Estate of Frane that the obligor’s basis in the assets acquired for the note equals the face amount of the note and not the amount actually paid. The Court quoted from a General Counsel’s Memorandum (which was not cited in the Court’s opinion), which concluded that obligor’s basis is equal to the face value of the note because Section 453B will tax the obligor on that amount of the appreciation so the obligor should get the benefit of the increased basis.

d. The terms of the note should not exceed the seller’s life expectancy or else the parties run the risk that the Service will reclassify the payments as annuity payments and the interest component of the payments will not be deductible by the buyer.

9. Private Annuity Sales

A private annuity accomplishes many of the same estate planning goals as an installment sale. A private annuity offers the opportunity to retain an asset in the family. Any gain on the sale is deferred and taxed proportionately as payments are received. A private annuity will provide the transferor with a fixed retirement income. Future appreciation of the transferred asset is removed from the transferor’s estate and only the payments received (and not consumed) are included in his or her estate.
a. There will be no gift if the private annuity payments are based on the current value of the property sold and the annuity payments are computed based on the methods and values set forth in Service Notice 89-60 and the tables in IRS Publication 1457, there was a real expectation of payment and payments were actually made.

(1) Valuation Issues:

(a) The value of the annuity payments may be calculated under Table S of the Service's valuation tables, as set forth in Reg. §20.2031-7(d)(6).

(b) Determining the value of the property being sold for purposes of determining the purchase price under a private annuity arrangement is very important. If the property is undervalued, the Service will find a part-sale, part-gift, and, given the annuity interest, the Tax Court has found a retained interest in the gifted property that will result in the inclusion of the property subject to the private annuity sale in the decedent's estate.

(2) Advantages and Disadvantages:

(a) The main disadvantage in a private annuity transaction is that the transferor may outlive his or her actuarial life expectancy. Thus, the estate tax on the annuity payments may exceed the estate tax that would have been attributable to the transferred asset if the private annuity transaction had not taken place.

(b) However, if the transferor dies before his or her life expectancy, or if the transferor consumes most or all of the annuity payments, then the asset will pass to a younger generation with little or no estate tax paid on the accumulated annuity payments. Moreover, if the property appreciates substantially in value, that increase in value is out of the decedent's estate, because the annuity was based on the value at the time of sale.

b. Other Requirements

(1) The annuity payments cannot be either directly or indirectly, tied to the income from the property.

(2) The annuity payments must be limited to or dependent upon the income from the property transferred.

(3) The annuity payments must be the personal, unsecured obligation of the transferee.

(4) The transferee/obligor must have assets and income that can support the annuity payments from sources other than the property transferred.

(5) The transferor cannot retain any ownership or control, direct or indirect, as to the property transferred.

(6) The transferor has not retained a security interest in the transferred property.
c. Basis Considerations

(1) The transferee’s basis in the property, at the time of the sale, is the present value of all future payments that will be paid if the transferor lives to his or her life expectancy. In other words, the basis is initially the fair market value of the property transferred.199/

(2) This basis is the value used at the outset in computing the transferee’s depreciation deduction. Once the annuity payments exceed the original fair market value of the property transferred, the excess payments will increase the obligor’s adjusted basis, thereby increasing the depreciation deductions. Once the transferor dies, the obligor’s adjusted basis will equal the total sum of the annuity payments minus any depreciation deductions, so that, if the transferor dies prior to his or her life expectancy, the basis may be required to be reduced (but only prospectively, not retroactively).

d. Income Tax Consequences of Payments

(1) No part of the annuity payments is considered interest; therefore, the obligor is unable currently to deduct any part of the annuity payments, except for any depreciation deductions.200/

(2) The income tax consequences to the transferor/annuitant are determined under the annuity rules.201/ Generally, to calculate the income tax consequences of an annuity, an exclusion ratio must be computed. The exclusion ratio is the percentage of each annuity payment that will be considered as a return of the annuitant’s investment in the annuity contract.

(3) In an unsecured annuity transaction, the transferor’s investment in the annuity contract is his basis in the property transferred. Thus, the exclusion ratio is computed by multiplying the annuity payments by the transferor’s life expectancy and then dividing this amount by the transferor’s adjusted basis in the property transferred.202/

(4) If the property transferred is a capital asset, then the difference between the fair market value of the property at the time of the transfer and the transferor’s adjusted basis will be recovered as capital gain ratably over the life of the annuity. The remaining part (if any) of the annuity payment will be ordinary income.

10. Sales to Grantor Trusts

a. Grantor Trusts

(1) A trust can be a completed gift for gift tax purposes but not complete for estate tax purposes and hence includable in the grantor’s estate. A trust can also be complete for estate and gift tax purposes but not effective for income tax purposes, which results in the grantor having to include the trust’s income in his own taxable income regardless of whether or not he receives the income.
(2) The latter alternative described above is usually referred to as a “grantor trust” and can provide the grantor with an estate and gift tax advantage, because the trust can grow without any reduction for its tax burden since the grantor pays the income tax on the income.\textsuperscript{203}

(3) In a grantor trust, the grantor is considered the owner of the trust for income tax purposes, and the Service frequently uses the term “alter ego” when describing such trusts.\textsuperscript{205} As a result, the grantor can put property in such trust and still receive all of the income tax advantages he would have received had the property remained in his name, but without the property being included in the grantor’s estate. These income tax advantages include the $250,000 exclusion ($500,000 for a husband and wife who file a joint Federal income tax return) of gain on property under Section 121.\textsuperscript{205} The Service has ruled that, since such a trust is an alter ego of the grantor, a transfer of a partnership interest to such trust will not cause the grantor to recognize gain to the extent of his negative capital account.\textsuperscript{206} At the grantor’s death, when the trust is no longer a grantor trust but becomes a separate taxpaying entity, then, so long as the gift was complete for estate and gift tax purposes when made, the trust property will not be included in the grantor’s estate, but it also will not receive a step-up in basis under Section 1014.\textsuperscript{207}

(4) The status as a grantor trust can be achieved by qualifying as such under the grantor trust rules of Sections 673 through 677.

(5) The grantor of a grantor trust may be considered the owner of the trust with respect to only corpus or only income or both.\textsuperscript{208} If a trust is considered a grantor trust with respect to only income, then the trust is a separate taxpaying entity with regard to principal transactions. In order to ensure that such trust is defective for purposes of both income and principal, the applicable provisions and the powers relating thereto should be specifically applicable to both trust principal and trust income.

(6) When the trust loses its status as a grantor trust (either because of the death of the grantor or the grantor’s renunciation of the grantor trust powers described above), the trust becomes a separate tax-paying entity. If the grantor is alive, the grantor will be treated upon the termination of the grantor trust, solely for income tax purposes, as though the grantor entered into the transaction at that time.\textsuperscript{208} It is unclear what happens if the grantor trust status is terminated as a result of the death of the grantor. It is also unclear under either scenario if the tax consequences that would have arisen if the trust had not been a grantor are brought back and recognized at the termination of the grantor trust or if only future tax consequences are recognized.

(7) All of the sale techniques described above can be accomplished utilizing a grantor trust. None of the income tax consequences described therein will, however, arise,\textsuperscript{210} which may alter the economics of the transaction.

(8) Example

$1,000,000 real estate with net return of 6% is transferred into LLC by Grantor. Grantor sells a 40% LLC interest to Grantor Trust.
1. Sale price: $280,000
($400,000 (40%) minus an assumed 30% discount)

2. Gift to Grantor Trust: $28,000
Grantor Trust should not be unfunded when entering into a purchase and 10% of the sale price is generally considered a safe amount. This gift is not eligible for the annual exclusion from gift taxes, since the annual exclusion requirements are incompatible with the grantor trust provisions.

3. Grantor Trust owns 40% of LLC and a 20 year promissory note payable to Grantor at 8% with a face amount of $280,000.

Year One:

(a) LLC pays Grantor Trust $24,000.
(This is 40% of 6% return from real estate).

(b) Grantor Trust pays Grantor $36,400
(note payments: principal $14,000, interest $22,400). Trust must use some of its gift to meet payment, and in less than three years the gift amount will be completely used up.

(c) Grantor pays income tax on $24,000, which is $9,504 (at 39.6% rate) on the LLC distribution to the trust. Grantor pays no income tax on the promissory note payment.

(9) If an individual has liabilities in excess of his or her basis (a negative capital account) in an asset that he or she wants to sell to the family, the sale will usually trigger the negative capital account which will result in taxable income to the seller in the year of the sale. It is possible to defer (but not eliminate) the triggering of such negative capital account by selling such an asset to a grantor trust. The seller, however, would only utilize this technique if he or she feels that the asset to be sold has such a great potential for appreciation that despite the ultimate recognition of income as a result of triggering the negative capital account, it is still better to remove the asset and its appreciation from the seller’s estate, because of the estate tax burden. The reason the seller should be aware of this is because, if the seller had done nothing, upon his or her death, the cost basis of all of the seller’s assets are increased to the
fair market value of such assets, determined as of his or her date of death. As a result, upon the
seller’s death, the negative capital accounts of such assets disappear and is never subject to
income tax, although the asset itself, at its then fair market value, is subject to estate tax.

(10) At the seller’s death, when the trust is no longer a grantor trust but becomes a separate taxpaying entity, then, so long as the gift was complete for estate and gift tax purposes when made, the trust property will not be included in the seller’s estate, but it also will not receive a step-up in basis under Section 1014. As a result, any negative capital account will then be triggered and recognized. The negative capital account will be probably be triggered in the trust’s income tax return,\footnote{\textsuperscript{216}} which would not give the seller’s estate an estate tax deduction, but the seller has succeeded in deferring the triggering of the negative capital account and removed the asset and its appreciation from his or her taxable estate.

(11) If, however, the balance of the note has been reduced through annual payments and the property has appreciated, a portion of the purchased property (and a portion of the negative capital account) could be used to prepay the note, thereby transferring the negative capital account back into the hands of the original owner where, upon such owner’s death, the trigger of such negative capital account will be offset by the increase in the basis of the asset. A proportionate interest in the asset, and its appreciation, however, will be includible in the owner’s estate. A recapitalization and repayment of the note with the recapitalized interest (and negative capital account) may also be possible, which would freeze the appreciation includible in the owner’s estate.

B. Joint Purchases

1. In the joint purchase arrangement, two or more persons simultaneously purchase a life interest and a remainder interest in the same property. Generally, the older generation purchaser would purchase the life interest in an asset (or assets), while his or her intended beneficiaries would purchase the remainder interest.

2. The advantage of a joint purchase is that when the owner of the life interest dies, nothing is includible in his or her estate and the remainderman receives the entire asset, free of any transfer tax burden. Furthermore, the payment for the life estate reduces the owner’s taxable estate.

3. Section 2702(c)(2), captioned “Joint Purchases”, covers the situation where two or more members of the same family, in the same transaction or series of related transactions,\footnote{\textsuperscript{215}} acquire a life interest and a remainder interest, respectively, in the same property. In the estate planning context, often an older generation purchaser acquired a specified income or term interest in an asset (or assets), while his or her intended beneficiaries acquired the remainder interest in such property. This arrangement was used to present the opportunity to freeze the value of or remove assets from the estate of the older generation purchaser.

4. Recently, the Service approved a joint purchase by family members of a commercial facility and found that a partner’s priority distributions that were set at a fixed rate (which interest was purchased by the partner) satisfied the rules of Section 2702 as a qualified
annuity. In addition, the Service approved a joint purchase through a qualified personal residence trust ("QPRT") of a residence by family members. In this scenario, the parents contributed cash to the QPRT equal to the parent’s lifetime interest in the house (determined actuarially) and the children contributed the remainder of the cash. The QPRT then purchased the house. No gift under Section 2702 occurred because QPRTs are an exception to Section 2702.

5. It is very important that each party use his or her own funds to acquire the interest, otherwise the Service will apply the step transaction doctrine to collapse the joint purchase.

6. Even if the taxpayer does not qualify for this treatment, the objective of freezing the value or removing assets from the estate can still be achieved, but at a higher gift tax cost.

a. For example, as the Regulations provide, if A purchases a 20-year term interest in an apartment building and A’s child purchases the remainder interest, and A and A’s child each provide the portion of the purchase price equal to the value of their respective interests in the property under Section 7520, then A is treated as acquiring the entire property and transferring the remainder to A’s child in exchange for the portion of the purchase price provided by A’s child. This gift of the remainder to the child, if the term interest is expressed (i) in a term for years and (ii) in the form of a qualified annuity, can be valued as a GRAT under the rules of Section 2702, thereby reducing the gift tax consequences, if the life tenant survives the term.

b. Under the Section 2702(a) rules, all the value is held in the remainder interest since A’s retained interest is valued at zero, so A made a gift equal to the full market value of the property minus the consideration paid by A’s child. When A dies, the property will escape inclusion in A’s estate under Section 2036(a) because there was no transfer and retention of an interest. The deemed transfer in trust applies solely for purposes of Section 2702, not for any other Code Section.

C. 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 gifted 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.\textsuperscript{222} 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.\textsuperscript{223} 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.\textsuperscript{224/}
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.\(^2\)

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.\(^4\)

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.\(^2\)

(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.\(^2\)

(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.\(^2\)

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.\(^2\)

IX. PLANNING FOR ESTATE TAX STATUTORY RELIEF

After transfer taxes have been reduced as much as possible and liquidity and wealth replacement has been provided for to the extent feasible, then the final issue that must be addressed is whether one of the estate tax statutory relief provisions can be utilized.

Under the Code, there are provisions that allow a taxpayer to value qualified real estate at less than its highest and best use, thereby reducing the estate tax cost of such property.
Furthermore, even if no such relief is possible, the Code nonetheless allows the deferral of the payment of estate taxes under certain circumstances. These Code Sections are discussed below.

A. Section 2032A

As previously stated, real property is generally valued at its fair market value, which is based on the property's highest and best use. Thus, for example, if a farm is situated near an urban area (assuming that zoning and the necessary utilities were all in place), its value may well be greater if it were subdivided for residential or commercial use than as farm property. As a consequence of valuation based on the highest and best use, substantially higher estate taxes might be imposed; and, in many cases, the greater estate tax burden would make the continuation of farming, or closely held business activities, not feasible because the income potential from these activities would not be sufficient to service extended tax payments or loans obtained to pay the estate tax. Thus, the heirs could be forced to sell the land for development purposes. For these reasons, among others, Congress added Section 2032A.

1. General Rules of Section 2032A

a. Assuming certain conditions are met, an executor may elect, under Section 2032A, to value real property used for farming or in a closely held business based on its value as such, rather than on the basis of its potential highest and best use.

b. In conjunction with the election, under Section 2032A(d)(2), all parties in being having an interest in the real property (whether or not in possession) must sign a written agreement consenting to the imposition of, and personal liability for any taxes assessed in the event that, within 10 years of the decedent's death, certain events set forth in Section 2032A(c) occur.

2. Consequences of Section 2032A Election

a. The reduction in the value of the qualified real property resulting from the application of the special use valuation cannot exceed $770,000 (or $385,000 in the case of a community property interest) in the year 2000. If more than one farm is used in electing Section 2032A value and the limitation imposed by Section 2032A(a)(2) is exceeded, the reduction must be allocated ratably among all farms for which the special valuation is elected.

b. The special use value establishes the basis of the qualified real property for income tax purposes.

3. Requirements of Section 2032A

a. Real property used in a farm, timberland, woodland, or other closely held business qualifies for special use valuation if the adjusted value of the real and personal property used in connection with the farm or closely held business accounts for at least 50% of the adjusted value of the gross estate.
b. The adjusted value of the real property must amount to at least 25% of the adjusted value of the gross estate.238

c. The value of a farm for farming purposes is determined as follows: The excess of (1) the average gross cash rental for comparable land used for farming purposes and located in the locality over (2) the average annual state and local real estate taxes for such comparable land is to be divided by the average annual effective interest rate for all new Federal Land Bank loans.239 However, under Section 2032A(e)(7)(C), the above formula is not to be used where it is established that there is no comparable land from which the average annual gross cash rental may be determined, or the executor elects to have the value of the farm for farming purposes determined in the same manner as other closely held business interests under Section 2032A(e)(8). Each average annual computation is to be made on the basis of the five most recent calendar years ending before the date of the decedent's death.259

d. The value of timberland, standing timber and woodland was established by the taxpayer and accepted by the Service because the taxpayer could provide leases of comparable land for the five years prior to the decedent's death.241

e. An executor should now be able to use both Section 2032A and a minority discount to reduce the value of a farm. In Estate of Maddox v. Commissioner,242 the decedent owned 35.5% of a family-owned incorporated farm. The Tax Court had not allowed the executors to reduce further the value of the farm as determined by Section 2032A by a minority discount. The Court noted that the election to value the real estate under Section 2032A means that the actual fair market value of the asset is not being used for estate tax valuation purposes. Inasmuch as minority discounts are only relevant in computing an asset's fair market value, a minority discount may not be used to reduce further the value of a farm valued under Section 2032A. In Hoover v. Commissioner,243 the Tenth Circuit held that to disallow a minority discount suggests that fair market value takes on a different meaning under §2032A than under other circumstances, and permitted the incorporation of a minority interest discount in the determination of value.

f. On the date of the decedent's death, the real property must have been in use by the decedent or a family member as a farm or for other business purposes.244 In addition, for at least 5 of the last 8 years preceding the decedent's death, the decedent or a family member must have (1) owned the real property, and (2) used the real property for farming or other trade or business purposes.245

g. The decedent or a family member must also have materially participated in the operation of the farm or other business for at least 5 of the last 8 years preceding the decedent's date of death, disability or commencement of Social Security retirement benefits.246

h. Real property owned indirectly through an interest in a partnership, corporation or trust qualifies for special use valuation to the extent it would qualify if it were owned directly.247 However, in order to qualify for the special use valuation in such a situation, the property must be clearly shown as being used in a trade or business, rather than held for mere passive rental. This means that the Service's interpretation of Section 6166, discussed below,
must be carefully analyzed, for only qualification under that Section would permit the use of Section 2032A.

4. Imposition of Additional Estate Tax

   a. The disposition (other than by involuntary conversion or the contribution of a qualified conservation easement on the subject property) of an interest in the qualified real property by a qualified heir (otherwise than to a member of his family) or the failure of the qualified heir to continue to use the qualified real property for the qualified use, as set forth in Section 2032A(c)(6), results in the imposition of an additional estate tax. This additional estate tax may be imposed within 10 years after the decedent’s death.

   b. If such a recapture tax is imposed because of disposition of the qualified real property or cessation of the qualified use, the basis of the qualified real property may be increased to its fair market value on the estate tax valuation date applicable to decedent’s estate. If the qualified heir elects this basis adjustment, interest must be paid at the annually adjusted floating rate of Section 6621 on the amount of the recapture tax from a date 9 months after the decedent’s death until the due date of the recapture tax.

5. Disadvantages of Section 2032A Election

   Although the special use valuation may provide some estate tax relief for estates which are comprised largely of qualified real property, many planners are reluctant to advise a client to make the election because of the complexity of Section 2032A, the potential for recapture, the personal liability of the qualified heir and the special lien. Where there are multiple qualified heirs, there is also the risk that they may disagree regarding the disposition or use of the property. In addition, the major benefit of special use valuation is the reduction in Federal estate tax due to the lower valuation; however, the property receives a lower basis based on this lower value. Thus, if the property is sold, there may be more gain to be recognized.

6. Relationship between Section 2032A and Section 2056

   Special consideration must be given to the interrelationship between special use valuation and the unlimited marital deduction. As a general rule, it appears that the executor and other parties should not elect to make use of special use valuation (with the consequent limitation on basis) where the real property passes to a surviving spouse in a way that qualifies for the unlimited marital deduction. Of course, use of the special use valuation method would increase the amount of property that could be sheltered by the decedent’s unified credit from inclusion in the surviving spouse’s estate. The decision will depend in part on the sizes of the decedent’s and surviving spouse’s estates, the amount of qualified real property included in the estates, and the survivor’s plans for use of the property.
B. Section 6166

1. General Rule

Under Section 6166, an executor may elect to pay all or a portion of the estate tax in two or more equal installments, but not more than 10 installments, if the decedent was a United States citizen or resident and his or her estate includes an interest in a closely held business which exceeds 35% of the decedent's adjusted gross estate. The deferrable portion of the estate tax is that fraction thereof which reflects the ratio that the closely held business bears to the adjusted gross estate.

2. Definitions of an Interest in a Closely Held Business

(a) An "interest in a closely held business" is (1) an interest in a sole proprietorship carrying on a trade or business; (2) an interest in a partnership carrying on a trade or business if 20% or more of the total capital interest in the partnership is included in the decedent's gross estate, or if there were 15 or fewer partners; or (3) stock in a corporation carrying on a trade or business if 20% or more in the value of the voting stock is included in the decedent's gross estate, or if there were 15 or fewer shareholders. For estates of decedents dying after December 31, 2001, the number of partners and shareholders allowed in a closely held business has been increased to 45.

(b) A great deal of controversy exists over whether the owner of real property, whether a farm or land improved by buildings, should be entitled to relief under Section 6166. Certain rules have emerged. Passive investments do not qualify as a "business." The "mere grouping together of income-producing assets" from which income is obtained only through ownership of the property, rather than from the conduct of a business, has been held not to be a trade or business. Furthermore, the Service recently issued a Ruling in which active businesses such as manufacturing mercantile or service businesses, in which Section 6166 would apply, were distinguished from the mere management of real estate assets which, under the ruling, was denied the Section 6166 extension.

(c) Examples

(1) Ownership of real estate was held not to be a trade or business even though, prior to his death, a decedent maintained a fully equipped business office to collect receivables, negotiated leases, made occasional loans, and by contract directed the maintenance of his properties, and even though the decedent maintained records and kept regular office hours for collection of the amounts involved and the maintenance of his properties. The Service held that "the decedent's relationship to the various assets described was merely that of an owner managing investment assets to obtain the income ordinarily expected from them."

(2) The ownership and rental of 8 homes, with regard to which the decedent collected rents, made the mortgage payments and made the necessary repairs and maintenance was also held not to be a trade or business.
(3) The ownership of farm real estate leased to tenant farmers under an agreement whereby the decedent received 40% of the crops and bore 40% of the expenses, and where the decedent participated in important management decisions and made almost daily visits to inspect the farms and discuss operations, although he lived several miles from the farms, was found to be a trade or business. The Service pointed out that: "An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of investment assets." Thus, where the decedent rented land to sharecroppers, but took part in farm management decisions, and received a portion of the produce, the business was active and the estate qualified for tax deferral under Section 6166. On the other hand, where the decedent owned property and merely rented it, the decedent was held merely to be managing passive assets.

(4) A trade or business was found from the ownership of stock in an S corporation which built homes on land owned and developed by the decedent. The Service ruled that land owned by the decedent which was held for the purpose of building homes by such corporation qualified as an interest in a closely held business for purposes of Section 6166, as did a business office and warehouse owned by decedent but used by both the decedent and the corporation in the home building and land-holding operations. Further, the estate could treat the interests in these two businesses as an interest in a single closely held business, under Section 6166(c).

(5) A trade or business was found where the decedent purchased, renovated, actively managed on a day-to-day basis, and leased commercial buildings. A trade or business was also found where the decedent owned a one-third interest in a trust that owned an operating business. The Service ruled that the trustee was the agent of the decedent.

(6) The Service found in one letter ruling that the decedent personally participated in acquiring and renovating real property and in its overall operation and therefore his management rose to the level of a trade and business that is eligible for a Section 6166 deferral. Furthermore, although the day-to-day operations were handled by corporations, these corporations were the decedent's agents, and their activities were attributed to the decedent. The Service found qualification for Section 6166 treatment because the decedent's activities "(as assisted) went beyond merely collecting rents, paying taxes, making mortgage payments and making necessary repairs (considered management of investments)."

(7) The decedent owned a one-half interest in a partnership that held no assets but provided bookkeeping services to the decedent's corporations and to the decedent himself, all of which owned real property. The Service found that all of the entities and the cash reserves, as well as the real property, constituted a trade or business eligible for Section 6166 deferral. The Service reached this result by analyzing what the cash reserves were used for (local property and payroll taxes, insurance, repairs, utilities and legal and accounting fees). The real property held by the decedent, either as tenant in common or through wholly owned S corporations, included apartment buildings and commercial buildings.
(8) The decedent owned tenant-in-common interests in two buildings and a one-third interest in a partnership holding buildings. The decedent’s activities included “tenant relations”, which involved interviewing and selecting prospective tenants and negotiating and enforcing leases; “administrative procedures”, which involved collecting rents, paying expenses, obtaining and reviewing insurance coverage; and “maintenance of property”, which involved making all repairs and improvements, inspecting property and providing services. When the decedent’s health failed, the decedent’s daughter took over these activities. The Service found that these activities involved the management of investment assets and did not rise to the level of an active trade or business and, as a result denied the Section 6166 extension.  

(9) The decedent owned a two-thirds interest in a partnership, the operation of which was an active cattle ranching business. Decedent also owned the land on which the business was located; however, the land was not held by the partnership, but by the decedent individually. The Service ruled that since the land was essential to the business, it was eligible for the Section 6166 deferral.  

(10) The decedent operated 11 properties and managed all aspects of leasing, management and maintenance. Even though shortly before his death the decedent gave up his responsibilities as a result of illness, the Service found that the properties were a trade or business for purposes of Section 6166, as a result of the level of the decedent’s activities prior to becoming ill.  

(11) The decedent was engaged in a commercial real estate development and leasing business. As part of his role in the business, the decedent maintained a business office at one of the properties, reported to the office daily, coordinated the employees’ daily activities, reviewed all invoices, signed all invoice and payroll checks, and negotiated all commercial leases. The Service held that the decedent actively participated in the management and operation of the properties and, thus, was engaged in a trade or business for purposes of Section 6166 of the Code.  

3. Election  

a. Once it is determined that a decedent’s estate is eligible for Section 6166, an irrevocable election must be made under Section 6166(d), for such deferral on the estate tax return. The first such installment is to be paid at the time the return is required to be filed under Section 6151(a), with the remaining installments paid annually on the anniversary dates thereof. As a practical matter, executors generally elect the longest payment period available, which is a 10-year period beginning on the fifth anniversary of the due date of the decedent’s estate tax return. The estate tax may always be prepaid without penalty. On the other hand, if an alternate payment term has been elected, it may not be extended if the date for making the original election (that is, the due date for filing the return as prescribed by Section 6075, including extensions) has passed.
(1) Interest at the rate of 2% is imposed on the lesser of:

(a) the amount of tax on the first $1,010,000 (for decedents dying in the year 2000) of the taxable value of the business; or

(b) the amount of estate tax deferred under Section 6166.282/

(2) The $1,000,000 amount will be adjusted for inflation; however, only by increments of $10,000.283/

(3) Interest at the rate equal to 45% of the annual rate provided by Section 6601(a) is imposed on the remaining estate tax defined under Section 6166.-b. The interest paid under Section 6166 is no longer a deductible expense on the estate tax return.285/ However, the excess interest on any overpayment of tax is deductible.286/

c. Once the property subject to the Section 6166 election is transferred, the unpaid estate tax will be due, although the Service recently ruled that a transfer of such property to a LLC did not accelerate the payment of the tax.287/

C. Section 6161

1. Even if an estate does not qualify for deferral of estate tax payments under Section 6166, the executor may request that the Service extend the time for payment of the estate tax due for up to 10 years upon a showing of “reasonable cause”.288/

2. The Service will look at the following factors in determining whether reasonable cause exists.289/

a. the executor’s inability to marshal assets to pay the estate tax;

b. the estate’s assets consist largely of the right to receive payments in the future (such as annuities, royalties, contingent fees or accounts receivable);

c. the substantial assets of the estate cannot be collected without litigation; and

d. the estate does not have sufficient funds available, after the making of reasonable efforts to convert assets (other than an interest in a closely held business) into cash, with which to pay the tax in a timely fashion.

3. An application containing a request for an extension of time for paying the estate tax must, under Reg. §20.6161-1(b), be in writing; state the period for which the extension is requested; include a declaration made under penalty of perjury; state the reasonable cause for
which the extension is requested; and be filed with the appropriate District Director on or before the date prescribed for payment of the tax.

4. The taxpayer usually is required to furnish a bond or other security. Interest will be charged at the current rate of interest, as determined under Section 6621.

§2501(a)(1). Unless otherwise noted, all reference to Sections (§) and Regulations in this outline are to
Sections of the Internal Revenue Code of 1986, as amended (the “Code”), and the Regulations thereunder.

Reg. §25.2511-1(c)(1).

§2511(a); Reg. §25.2511-1(a).

The Economic Growth and Tax Relief Reconciliation Act of 2001, §511(d).

The Economic Growth and Tax Relief Reconciliation Act of 2001, §511(d).

Code §2502(a).


§2503(b)(2), as amended by the 97 Act §501(c)(3).

But see Nordstrom v. U.S., 97-1 USTC ¶60,255, 79 AFTR 2d 612 (N.D. Iowa 1996), where the spouse’s
consent was a question of fact.

Reg. §25.2503-3(a). See Estate of Holland v. Comm’r, 73 TCM 3236 (1997). See also TAM 9751003
(August 28, 1997), in which the Service ruled that gifts of interests in a family limited partnership did not
qualify for the annual exclusion because they constituted gifts of future interests. The interests did not provide
for a steady and ascertainable flow of income, which would make the interests gifts of present interests,
because the general partner had the ability to retain income for any reason, thereby making it uncertain
whether any income would be distributed to the limited partners. But see TAM 199944003 (July 2, 1999),
holding that gifts of limited partners interests qualified as annual exclusion gifts. The Service stated that “The
Taxpayer [who was the general partner of the family limited partnership] possesses no powers as a general
partner that are not otherwise contained in a standard limited partnership agreement.”

§2503(e).

§2503(e)(2)(A).

§2503(e)(2)(B). The term “medical care” is defined in §213(d), but, as set forth in Reg. §25.2503-6(b)(3),
includes amounts paid for medical insurance.

Reg. §25.2503-6(a).

§2523(b). See Ltr. Rul. 9139001 (April 30, 1991) and Ltr. Rul. 9147065 (July 12, 1991), where trust was not
eligible for marital deduction if a third party had a right to exercise option to purchase closely held shares held
in the trust at book value.

§§2523(e) and (f). The spouse’s possible incapacity will not destroy the marital deduction. Ltr. Rul. 9514002
(December 20, 1994).

§2523(e)(2) and 2523(f)(3).

§2523(e).

§2523(f)(4).

§2044.

When an individual makes an outright gift of real property and retains a right to mine minerals from the gifted
real property, if the probability of surface mining is so remote as to be negligible, such retained right will not
preclude the charitable deduction. §170(h)(5)(B)(ii), as amended by 97 Act §508(d).

§2522(c)(2).
The unified gift tax credit must be used to reduce a donor's gift tax liability in the gift tax period when the liability occurs. Gifts are to be reported on a Federal Gift Tax Return (Form 709 or 709-A).

IRC §6018(a)

§1015(a); Reg. §1.1015-1(a)(1).

Reg. §1.1015-1(a)(2).

§1015(a); Reg. §1.1015-1(a)(3).

§1015(d).

§643(c)(1).

Reg. §1.267(d)-1(a)(2) and (4).

§2032A.

§2031.

§1014(a)(1), (2) and (3). As to decedents dying after July 18, 1984, the alternate valuation date may be elected only where the election will decrease the value of the gross estate and the estate's total Federal estate tax liability. §2032(c).

§1014(c).

Reg. §1.691(a)-1(b). See Ltr. Rul. 9325029 (March 25, 1993), holding that options granted to decedent during her lifetime, but exercisable after death, are not income in respect of a decedent.

§1014(a)(4), as amended by 97 Act §508(b).

§2040(b)(1) and 1014.

§2040(b)(2).


§754.

Reg. §1.743-1(b).

§743(a).

§754.

§732(b).

§1022, as added by 2001 Act §542(a).

§1022(a)(2), as added by 2001 Act §542(a).

§1022(b)(2)(B), as added by 2001 Act §542(a).

§1022(b)(2)(C), as added by 2001 Act §542(a).

§1022(c)(2)(B), as added by 2001 Act §542(a).

§1022(b)(3)(A), as added by 2001 Act §542(a).

§1022(d)(4), as added by 2001 Act §542(a).

§1022(d)(3), as added by 2001 Act §542(a).

§1022(d)(2), as added by 2001 Act §542(a).

§1022(e), as added by 2001 Act §542(a).

§1022(d)(1)(A), as added by 2001 Act §542(a).


§1022(d)(1)(B)(i)(II), as added by 2001 Act §542(a).

§1022(d)(1)(B)(ii), as added by 2001 Act §542(a).

§1022(d)(1)(B)(iii), as added by 2001 Act §542(a).

§1022(d)(1)(C)(i), as added by 2001 Act §542(a).

§1022(f), as added by 2001 Act §542(a).

§1022(d)(1)(D)(i), as added by 2001 Act §542(a).

§1022(d)(1)(D)(ii), as added by 2001 Act §542(a).

§1022(d)(1)(D)(iii), as added by 2001 Act §542(a).

§1022(d)(1)(D)(iv), as added by 2001 Act §542(a).

§1040(a), as amended by 2001 Act §542(d).

§1022(g)(1), as added by 2001 Act §542(a).

Id.
§2001(f), as amended by 97 Act §506(a), and §6501(c)(9), as amended by 97 Act §506(b); see Prop. Reg. 106177-98, 63 Fed. Reg. 70, 701, December 2, 1998.


Reg. §301.6501(c)-1(f)(2).

Reg. §301.6501(c)-1(f)(3).

Reg. §301.6501(a)-1.

Reg. §301.6501(c)-1(f)(4).

§7477(a), as added by 97 Act §506(c)(1).


But see §469(c)(7) and Reg. §1.469(f).


See Juden v. Comm'r, 865 F.2d 960 (8th Cir. 1989).

See Estate of Feuchter v. Comm'r, 63 TCM 2104 (1992), increasing land’s value for agricultural use to reflect the potential of certain tracts for residential uses and to reflect the prospect of long-term speculative development. See also Stanley Works v. Comm'r, 87 T.C. 389 (1986), and Estate of Lloyd v. Comm'r, 71 TCM 2846 (1997), where Court allowed evidence of imminent condemnation proceeding to depress value of land.

See Gettysburg Nat. Bank v. U.S., 806 F. Supp. 511 (M.D. Pa. 1992), holding that real estate appraised at $115,000 at time estate tax return was filed and sold 16 months later to a third party for $84,000 could be revalued at lower price as the discrepancy between the appraisal and sales figures did not result from any material change in the property or the market; but see Proios v. Comm'r, 68 TCM 645 (1994).

For a discussion of the three methods to value real estate, see Estate of Berg v. Comm'r, 61 TCM 2949 (1991), aff'd in relevant part 976 F.2d 1163 (8th Cir. 1992).

See Rev. Proc. 79-24, 1979-1 C.B. 565. See also Lewis v. U.S., 71-1 USTC ¶ 12,739 (D. Wyo. 1970); and Slater v. Comm'r, 18 TCM 557 (1959). Note that either the actual sale of the property or a sale of comparable property may be utilized in determining value.

See Rev. Proc. 79-24, 1979-1 C.B. 565. See also Estate of Ratcliffe v. Comm'r, 63 TCM 3068 (1992), using comparable sales approach with adjustments to account for the subject property's lack of a sewer connection.

See Training Manual for Estate Tax Examiners, at §5.044. See also Smith, Issues and Problems in the Valuation of Real Estate, 30 NYU Inst on Fed Tax’n 209, 229-230 (1972). See also Williams v. Comm'r, 32 TCM 291 (1973), noting that the deletion of some items, “particularly income taxes and interest, is a controversial practice”.

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See Smith, Issues and Problems in the Valuation of Real Estate, 30 NYU Inst on Fed Tax’n 209, 231 (1972). See also Estate of Bennett v. Comm’r, 65 TCM 1816 (1993), increasing discount rate from 11% to 14% in order to reflect the risk that the full amount of ground rents might not be collectible.


Smith, Issues and Problems in the Valuation of Real Estate, 30 NYU Inst on Fed Tax’n 209, 222 (1972). See Rev Proc 66-49, 1966-2 C.B. 1257, indicating there must be a “probative correlation between the costs of reproduction and fair market value”. See also Brigham v. Comm’r, 64 TCM 244 (1992), rejecting the replacement cost method of valuation for a water tower and surrounding land on the basis that the water tower was not worth replacing; Estate of Palmer v. Comm’r, 839 F.2d 420 (8th Cir. 1988), rev’g and remanding 86 T.C. 66 (1986).


§7517.

§§7517(a), (b).

§7517(c).


See Knight v. Comm’r, 115 T.C. No. 36 (November 30, 2000).

§6662(g). For returns filed after 1984 and due before January 1, 1990, see repealed Section 6660 for underpayment penalties.

§§6662(a), (g).

§6662(h)(1).

§6662(h)(2)(C).


See McCord v. Comm’r, 120 TC No. 13 (2003) (holding lack of marketability discount of 20% appropriate to determine fair market value of gifted interests in family limited partnership based on studies that compared private-market price of restricted shares of public companies with their public-market price during same period); Estate of Ford v. Comm’r, 53 F3d 924 (CA8 1995) (allowing a 20% minority interest discount and 10% lack of marketability discount when valuing stock of closely held corporation); Gross v. Comm’r, 78 TC 201 (1999) (allowed 25% lack of marketability discount based on the company’s generous dividend policy and the stock’s significant marketability restrictions); Estate of Dougherty v. Comm’r, 59 TCM 773 (1990), and Estate of Bennett v. Comm’r, 65 TCM 1816 (1993); but see Estate of Jephson v. Comm’r, 87 T.C. 297 (1986). See also Pillsbury v. Comm’r, 64 TCM 284 (1992), where a 15% discount was allowed although the decedent owned a majority interest (77%) in the entity, and Estate of Gray v. Comm’r, 73 TCM 1940 (1997), where a 15% discount was allowed even though decedent owned approximately 82% of the entity; but see Cloutier v. Comm’r, 71 TCM 2001 (1996), in which, as a result of poor appraisals, the lack of marketability discount was lost.

These two discounts (the minority interest discount and the lack of marketability discount) generally are found with respect to transfers of stock in closely held corporations, and the following are examples of these types of transfers:

In Ford v. Comm’r, 66 TCM 1507 (1993) the Court applied a 20% minority interest discount to the value of two corporations in which the estate had a minority interest, but then applied an additional 10% lack of
marketability discount to the value of all corporations, even ones in which the decedent held a controlling interest.

In 1994, the Tax Court approved a 40% discount for lack of marketability of stock held in Joseph Lauder's estate, but also reminded the Service and the taxpayer that (i) if there is a publicly traded company that is in a similar line of business, this must be considered, and (ii) these matters are best resolved outside of litigation. Estate of Lauder v. Comm'r, 68 TCM 985 (1994)

In 1995, the Tax Court addressed these discounts a number of times, usually with a favorable result to the taxpayer. In Trenchard v. Comm'r, 69 TCM 2164 (1995) the Court applied a control premium to the decedent's stock to reflect his operating and voting control, but also applied a discount for lack of marketability to all the decedent's stock to reflect the absence of an established market for closely held stock. The Court stated that the control premium is separate and apart from any discount that may apply and control does not mean the stock is any more or less marketable. In Mandelbaum v. Comm'r, 69 TCM 2852 (1995) the Court applied a 30% lack of marketability discount, based on a list of factors which included (i) an analysis of the corporation’s financial statements; (ii) the nature of the corporation’s financial statements; (iii) the corporation's dividend paying capacity and its history of paying dividends; (iv) the nature of the corporation and its management; and (v) the cost of going public. Finally, in McCormick v. Comm'r, 70 TCM 318 (1995) the Court applied minority interest discounts ranging from 24% to 32% and lack of marketability discounts ranging from 20% to 22%. The three factors the Court considered relevant were the size of the interest, the risks inherent in the business conducted by the entity and the restrictions on transferability.

In 1996, a District Court in the Fifth Circuit allowed a 10% minority discount even though the decedent held 50% of the voting stock of the corporation, since a 50% interest does not allow the decedent to control the management of the company, only to block any proposed action and, as the Tax Court pointed out, a minority discount is based on the lack of control. Wheeler v. U.S., 96-1 USTC 60,226 (W.D. Tex. 1996), reversed on other grounds, 116 F.3d 749 (5th Cir. 1997) The Tax Court also acknowledged in a case decided in 1996 that a marketability discount may be available in cases where decedent owned 100% of the stock of a corporation, but did not grant such a discount because the appraiser failed to establish a basis for such discount. Cloutier v. Comm'r, 71 TCM 2001 (1996) Finally, the Tax Court allowed a 19% minority discount and 26% lack of marketability discount. Barudin v. Comm'r, 72 TCM 489 (1996)

In 1998, the Tax Court allowed a 40% discount for a minority holding of common stock of a closely held grocery chain, citing a lack of a market for the stock, a restrictive buy-sell agreement, the lack of comparables and the decedent's minority interest. Brookshire Estate v. Comm'r, 76 T.C. 659 (1999)

The Second Circuit allowed a taxpayer to reduce the value of closely held stock, for Federal gift tax purposes, to take into account potential capital gains tax liabilities if the corporation liquidated, distributed or sold its sole asset, a commercial building, even though no such liquidation, sale or distribution was planned. Eisenberg v. Comm'r, 155 F.3d 50 (2d Cir. 1998) The Court reasoned that, because the capital gains tax will in all events ultimately be incurred, the capital gains liability is not too speculative to be valued as of the date of the gift.

In 2000, the Tax Court allowed a 15% lack of marketability discount and a 7.5% lack of control discount (since 2/3 voting majority was needed for control) to an estate that held 63% of a corporation's outstanding shares. Estate of Dunn v. Comm'r, 79 TCM 1337 (2000)

[As discussed below, the Service has taken the position that the “swing vote” attached to a gifted interest could destroy any possible discount (or, perhaps, result in a premium). Ltr. Rul. 9436005 (May 26, 1994) This Letter Ruling involved a situation in which three 30% blocks of stock were gifted to the donor's children, which gave each child the ability to control the corporation by voting with one other child. This Service position is unrealistic, and difficult to accept. Among other things, it creates a form of family attribution not present in the Code and specifically rejected in Rev. Rul. 93-12, 1993-1 C.B. 298.]

The following are examples of cases in which a discount was allowed in valuing direct or indirect interests in real property:

In Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982) the decedent died owning certain community real property with his wife. The executrix claimed, and the Court allowed, a 15% valuation discount to account for the relative unmarketability of an undivided fractional interest in the property.
Estate of Andrews v. Comm'r, 79 T.C. 938 (1982), involved ownership by the decedent of approximately 20% in four closely held corporations. All four corporations were involved primarily in the ownership, operation and management of commercial real estate. The real estate holdings included warehouses, commercial office space, retail space, factories and apartment buildings. The Court allowed a minority interest discount of 60% based on the lack of control that could be exercised by any purchaser of decedent's interest, and such purchaser's inability to sell such shares in the marketplace. The Court concluded that there was no family attribution for purposes of determining whether the decedent did, in fact, hold a minority interest.

In Estate of Sels v. Comm'r, 52 TCM 731 (1986), the Court applied a 60% discount to undivided interests ranging from 2% to 25% in 11 different tracts of timberland. Later, the Court applied a 40% valuation discount to a taxpayer's 20% undivided interest in 1,212.4 acres of farmland (the balance of which was owned by members of his family). Estate of Wildman v. Comm'r, 58 TCM 1006 (1989). This discount factor reflected a 15% minority interest discount plus a 10% discount to account for the fact that the irrigation facilities relative to this land were not owned by the landowners and plus a 15% discount to account for potential impediments to the sale of the property as well as possible litigation or partition expenses. (See also Estate of Bennett v. Comm'r, 65 TCM 1816 (1993), allowing a 15% lack of marketability discount even though 100% of the closely held corporation stock was held in a grantor trust; and Moore v. Comm'r, 62 TCM 1129 (1991), in which the Court held that a 35% discount for a minority partnership interest was appropriate.)

In Estate of Berg v. Comm'r, 61 TCM 2949 (1991), aff'd in relevant part 976 F.2d 1163 (8th Cir. 1992), the Eighth Circuit upheld the Tax Court's determination that decedent's shares of stock in a closely held real estate holding company, representing 27% of the company, should be discounted by 30% — representing a 20% discount because decedent owned a minority interest in the corporation plus a 10% discount because of the lack of marketability of such interest. The Berg Estate claimed an aggregate 60% discount, comprised of a 40% minority interest discount and a 20% discount for lack of marketability.

In 1998, the Tax Court allowed a 44% discount for the decedent's one-half interest in certain parcels of timberland owned at the time of her death. Williams v. Comm'r, 75 TCM 1758 (1998). The IRS argued that the discount should be limited to 5%, based on its estimate of the cost of partitioning the properties, but did not offer any evidence in support of its valuation. The taxpayer, however, presented four expert witnesses. The Court focused on the following testimony of such experts in allowing the discount: (i) banks will not lend money to an owner of a fractional interest in real property without the consent of the co-owner; (ii) a market discount is appropriate because of a projected nine-month marketing time and 10% real estate commissions; (iii) the holder of a fractional interest cannot unilaterally decide how the property should be managed; (iv) a partition action involves considerable time and expense; and (v) selling an individual fractional interest in real property presents difficulties.

In 1999, the Tax Court allowed discounts of 50% and 65% for gifts of assignee interests (rather than limited partner interests) in a FLP. Estate of Nowell v. Comm'r, 77 T.C. 1239 (1999).

In the same year, the Tax Court allowed an overall discount of 76% for a decedent’s minority interest in two closely held corporations, one of which owned and operated a farm. Estate of Smith v. Comm'r, 78 TCM 745 (1999). This large discount was awarded despite the provision in the corporate documents that the decedent was entitled to distributions to the extent necessary to meet the shareholder’s income tax burden.

Recently, the Tax Court allowed a 20% lack of marketability discount to a 25% limited partner interest in a partnership holding an apartment building. Weinberg Estate v. Comm'r, 79 TCM 1507 (2000). What is most interesting about this case is not the size of the discount, but the method by which the Court valued the partnership which, together with the lack of marketability discount, resulted in a discount of almost 50% of the decedent’s percentage interest in the underlying assets.

The following are examples of cases in which a discount was denied in valuing direct or indirect interests in real property:

In Estate of Young v. Comm'r, 110 T.C. 297 (1998), the Court denied the fractional interest discount taken by the estate on real property that the decedent owned as a joint tenant with his wife. The estate argued that Section 2033 of the Code, which provides that property in which the decedent had an interest must be included in the gross estate, has been held to allow fractional interest and lack of marketability discounts. The estate further argued that Section 2040 of the Code provides for the inclusion of jointly held property in the gross estate, but does not speak to the valuation of such property. Thus, the IRS cannot construe Section 2040 to
deny fractional interest and lack of marketability discounts to the estate. The Court disagreed and stated that the fractional interest discount allowed under Section 2033 is based on the rights of a tenant in common under local law which arise from the unity of interest and the unity of possession. The fractional interest discount is only appropriate when a partial interest in property would sell for its proportionate share and the lack of marketability discount arises from the difference in selling such partial interests. Joint tenancies, however, provide for a right of survivorship; thus, no tenant can devise the property to anyone other than the other joint tenant. Since there are no co-ownership problems at the moment of death, neither fractional or lack of marketability discounts are appropriate for estate tax purposes.

In Estate of Fratini v. Comm'r, 76 TCM 342 (1998), the Court held that the estate was not entitled to fractional interest discounts with respect to property held in joint tenancy with the right of survivorship. In determining the amount included in decedent's estate pursuant to Section 2040, the estate reduced the value of the decedent's interest in several of the jointly held real properties by fractional interest discounts. The Court, however, disallowed the claimed fractional discounts because, under Section 2040(a), the amount includable in a decedent's gross estate does not depend on a valuation of property rights actually transferred at death, or on a valuation of the actual interest held by the decedent (legal title). The decedent's gross estate includes the entire value of property held in a joint tenancy by the decedent and any other person, except to the extent the consideration for the property was furnished by such other person. In addition, Section 2040(a) provides an artificial inclusion of the joint tenancy property: the entire value of the property less any contribution by the surviving joint tenant. Except for the statutory exclusions in Section 2040(a), there is no further allowance to account for the fact that less than the entire interest is being included.

Reg. §20.2031-2(e); Estate of Auker v. Comm'r, 75 TCM 2321 (1998); Estate of Foote v. Comm'r, 77 TCM 1356 (1999). The Service has held, however, that nine gifts of stock, which if given to one donee may have entitled the donor to a blockage discount (given the impact of selling that amount of stock would be on the market), cannot be aggregated in order to obtain this discount, but must be considered separately. Ltr. Rul. 9719001 (November 19, 1996). This is contrary to the Service's position on the swing vote premium discussed below.

119/ Reg. §20.2031-2(e); Estate of Auker v. Comm'r, 75 TCM 2321 (1998); Estate of Foote v. Comm'r, 77 TCM 1356 (1999). The Service has held, however, that nine gifts of stock, which if given to one donee may have entitled the donor to a blockage discount (given the impact of selling that amount of stock would be on the market), cannot be aggregated in order to obtain this discount, but must be considered separately. Ltr. Rul. 9719001 (November 19, 1996). This is contrary to the Service's position on the swing vote premium discussed below.


122/ Estate of Welch v. Comm'r, 208 F.3d 213 (6th Cir. 2000).


127/ Simplot v. Comm'r, 249 F.3d 1191 (9th Cir. 2001).


129/ Ltr. Rul. 9449001 (March 11, 1994), in which simultaneous gifts to 11 family members of all stock of a closely held corporation were valued separately based on what each donee received, not on what the donor owned. But see Cidulka v. Comm'r, 71 TCM 2355 (1996), where a gift of a minority interest in a company to a child, combined with a corporate redemption that took place the same day, which had the effect of making such child a majority holder of the company, was denied any minority discount.


See Kerr v. Comm'r, 113 T.C. 449 (1999), where the Court held that a term for years was not an applicable restriction. See also FSA 199919009 (May 12, 1999), where the Service ignored the term for years in the agreement because it was not a definite term (50 years or until the general partner and majority of limited partner interests agreed to terminate).


Reg §25.2703-1(a)(1). Note that a perpetual restriction on the use of real property that qualified for a charitable deduction under either IRC §2522(d) or 2055(f) is not considered a right or restriction.

Reg §25.2703-1(b).

See Regs. §§25.2703-1(a) and (b)(3).

Estate of Gloeckner v. Comm'r, 71 TCM 2548 (1996), rev'd, F. Gloeckner Estate, 152 F.3d 208 (2nd Cir. 1998), where the Court found that the business associate that was purchasing the stock did not have a familial relationship with the decedent.

Reg. §25.2703-1(b)(4)(i); see also Estate of Gloeckner v. Comm'r, 71 TCM 2548 (1996), rev'd, F. Gloeckner Estate, 152 F.3d 208 (2nd Cir. 1998), wherein the Appeals Court found a bona fide arrangement that was not a device.


See Estate of Schauerhamer v. Comm'r, 73 TCM 2855 (1997). Recently, in TAM 199938005 (June 7, 1999) the Service held that under §2036(b) (if the donor retains the right, directly or indirectly to vote gifted stock in a controlled corporation) such stock that was transferred into a family limited partnership, the limited partner interests of which were gifted by the transferor/general partner, were includible in the general partner's estate.

Ltr. Rul. 9336002 (May 28, 1993). But see Estate of Cervin v. Comm'r, 68 TCM 1115 (1994), in which the Court allowed a 20% discount for the cost of partition, which, under Texas law, must be paid by the purchaser; LeFrak v. Comm'r, 66 TCM 1297 (1993), in which the Court gave a 10% lack of marketability discount in addition to a 20% discount for the cost of partition; and Estate of Barpe v. Comm'r, 73 TCM 2615 (1997), where the Court discounted the value of timberland (valued using the capitalization method) to take into account the effect of partition. See also TAM 199944003 (July 2, 1999).


§2036(a).

See Strangi v. C.R., T.C. Memo. 2003-145, T.C.M. (RIA) P 2003-145 (2003) (holding that, even though decedent owned only 47% of the LLC that held the general partner interest in a family limited partnership, decedent, through the explicit provisions of the governing instruments, had ascertainable and legally enforceable rights to designate persons who would enjoy the transferred property and its income through his ability to act, alone or in conjunction with others, to cause distributions of property previously transferred to the entities or of income therefrom).

The presence of an independent third party owner of a limited partner interest may invoke the protection of U.S. v. Byrum, 408 U.S. 125, 92 S. Ct. 2382, 33 L. Ed. 2d 238 (1972), where the Supreme Court held that, despite decedent's retained right to vote 71% of a corporation after transferring minority interests to his children, the decedent's fiduciary...
duty as a majority shareholder not to misuse power by promoting personal interest at the expense of corporate interest negated his Section 2036(a)(2) right to designate the persons who shall receive income from the transferred shares. A key fact supporting the Supreme Court’s ruling was that a substantial number of minority shareholders were unrelated to the decedent.

IRC § 705(a)
IRC § 752(b), 731(a).

Caveat: In avoiding gain recognition, out-of-pocket dollars may need to be spent and/or the value of the gift may be increased.

See Shepherd v. Comm., 2002 WL 312533 (CA 11 2002), holding that the taxpayer made an indirect gift of land to his two sons rather than a gift of partnership interests. The valuation of the gift was not determined by reference to the sons’ indirect ownership of the land through the partnership after the transfer and so discounting was not permitted.

No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse.

See, e.g., Estate of Casey v. C.I.R., T.C. Memo. 1996-156, T.C.M. (RIA) P 96156 (1996) (where the Court found no business purpose behind formation of a trust to liquidate a residence, and therefore denied all discounts in value, other than a 15% discount to reflect a delay in realization of the liquidation value.

See Turner v. C.I.R., 382 F.3d 367 (3rd Cir. 2004), affg Estate of Thompson v. C.I.R., T.C. Memo 2002-246 (holding full date of death value of assets transferred by decedent to family limited partnership at age 95 is included in decedent's gross estate after finding decedent retained lifetime control and enjoyment of the transferred assets, and concluding the transfer of assets was not a bona fide sale for adequate and full consideration); Strangi v. Comm., 96 A.F.T.R.2d 2005-5048 (5th Cir. 2005) (one of court's holdings was that no business or significant non-tax purpose existed for the creation of a partnership to hold 98% of decedent's assets; transfers should be included in decedent's estate under Section 2036(a)); See also Ltr Rul 9730004 (April 3, 1997), where the IRS disregarded a transfer of farmland to a partnership for estate tax valuation purposes; see also Ltr Rul 9719006 (Jan. 14, 1997) and Ltr Rul 9725002 (March 3, 1997).


Reg § 20.2036-1(a).

See, e.g., Rev Rul 81-15, 1981-2 IRB. 26; Ltr Rul 9546006; Ltr Rul 954007; Ltr Rul 9415007; Ltr Rul 9310039.


See Hacki v. C.I.R., 335 F.3d 664 (7th Cir. 2003) (holding that where partnership historically made no distributions due to negative cash flow, transferred limited partner interest was not gift of present interest because such transfer did not confer on donee substantial present economic benefit); and TAM 9751003 (Aug. 28, 1997) where a partnership agreement gave the general partner the discretion to distribute income to the limited partners and restricted ability of limited partners to transfer or assign their interests beyond the customary restrictions impose on limited partners, the gift tax annual exclusion was denied for lack of substantial present economic benefit).


Ltr Rul 7824005 (March 2, 1978).


See Reg § 1.704-1(e).

Reg § 301.7701-3(a).

See, e.g., VA Code Ann § 13.1-1046. See also ch 9A above.

§2702(b). For a discussion of the zero valuation rule of Section 2702, see Harris, Avoiding Double Taxation on Zero-Valuation Transfers under Section 2702, 12 The Practical Tax Lawyer 25 (Summer 1998). §2702(e), 2704(c)(2).


§453(d).

§453(b)(1). See, however, as to installment sales of depreciable property between related persons, §§453(g)(1), 1239(b).

§453(c).
§453B. See also §§453(e), 453C.


98 T.C. 341 (1992), aff'd and rev'd 998 F2d 567 (8th Cir. 1993).

§2512(b); Reg. §25.2512-5. However, a taxpayer may not use the annuity tables if his death was imminent at the time the private annuity agreement was executed. See McLendon v. Comm'r, 66 TCM 946 (1993), rev'd in part and remanded 77 F.3d 477 (5th Cir. 1995), modified 71 TCM 42 (1996). The Service issued final Regulations effective as of December 13, 1995, which contain the rules as to when the annuity tables may be used to value annuities, interests for life, term of years and remainder interests under §7520. Reg. §25.7520-3.

See Ltr. Rul. 9513001 (November 28, 1994).


See discussion on self-cancelling installment notes wherein a buyer may pay less for the property (in the event of the seller's premature death), but will never pay more for the property than its fair market value at the time of the sale plus the risk premium.

Contrast lack of collateralization on the debt with self-cancelling installment note, where collateralization is permissible.

See Rev. Rul. 68-183, 1968-1 C.B. 308, where the Service ruled that a transferor who transferred stock to a trust in exchange for a private annuity was treated as the owner of the trust because the only source of income to pay the private annuity was the transferred stock.


See Bell v. Comm'r, 76 T.C. 232 (1981), aff'd. 668 F.2d 448 (8th Cir. 1982). See discussion on self-cancelling installment notes, where interest paid on note is deductible.

§72; Reg. §1.72-9.

At one time, the Service took the position that, where the grantor pays the tax on such income that is includable in his or her taxable income, such payment should be considered a gift. Ltr. Rul. 9444033 (August 5, 1994); however, the Service withdrew this ruling and re-released it without this controversial position. Ltr. Rul. 9543049 (August 5, 1995).

Rev. Rul. 85-13, 1985-1 C.B. 184; Rev. Rul. 92-84, 1992-2 C.B. 216; Ltr. Rul. 9504021 (October 28, 1994). The 97 Act repealed the rollover provisions of §1034; however, the Service has not ruled on whether the revised §121 applies to grantor trusts; the Service took the position in Ltr. Ruls. 9321050 (February 25, 1993) and 9309023 (December 3, 1992), that §121 and §1034 apply to the sale of the grantor's residence made by a grantor trust, and there is no reason to believe they would rule otherwise under the revised §121.

Ltr. Rul. 9010065 (December 13, 1989); Ltr. Rul. 9838017 (June 19, 1998).

§1015(b).

Reg. §1.671-3.


Reg. §25.2702-4(c).
expenses may not be used in its entirety to meet the 50% requirement. See Estate of Mapes v. Comm'r, 99 T.C. 27 (1992).

§2032A(b)(1)(B).

§2032A(e)(7)(A). In Estate of Klosterman v. Comm'r, 99 T.C. 16 (1992), the taxpayer argued that amounts collected from tenants equal to charges imposed by an irrigation district to operate an irrigation system constituted state or local real estate taxes which would be deductible from gross cash rental. The Court rejected the argument and held that the charges had the effect of increasing the value of the assessed property.

§2032A(e)(7)(A).


93 T.C. 228 (1989).

§2032A(b)(1)(C). See also Ltr. Rul. 9433003 (April 29, 1994).

§2032A(g).

§2032A(c)(8), as amended by 97 Act §508(c).

Ltr. Rul. 9642055 (July 24, 1996).

§2032A(c). A qualified heir may now lease the farm to a family member on a net cash lease basis and not trigger the §2032A recapture. §2032A(c)(7)(E), as amended by 97 Act §504(a). See Ltr. Rul. 9519015 (February 7, 1995), in which a transfer to a revocable trust was not considered a disposition for purposes of §2032A. See also Ltr. Rul. 9503015 (October 21, 1994), where a §1031 exchange of §2032A property is not considered a disposition; and Estate of Hohenstein v. Comm'r, 73 TCM 1886 (1997), where leasing property to an unrelated party was considered a cessation of the qualified use.

§2032A(c)(1).

§1016(c)(4).

§1016(c)(5)(B).

§6166(a)(1). Unlike what constitutes qualified property for purposes of §2032A, cash has been held to be includable in the decedent's trade or business for purposes of §6166. Ltr. Rul. 9250022 (September 11, 1992).

§6166(a)(2).

§6166(b)(1)(A).

§6166(b)(1)(B), as amended by 2001 Act §572(a).

§6166(b)(1)(C), as amended by 2001 Act §572(a).

§6166(b)(1)(B) and 6166(b)(1)(C), as amended by 2001 Act §572(a).

§6166(b)(9). See Ltr. Ruls. 8448006 (August 20, 1984), 9128024 (April 12, 1991), 9403004 (October 8, 1993), 9422052 (March 9, 1994), 9517006 (January 10, 1995), 9602017 (October 11, 1995), 9621007 (February 13, 1996); 9801009 (September 26, 1997), and 9832009 (May 6, 1998). For estates of decedents dying after December 31, 2001, passive assets do not include stock in a qualifying lending and finance business. §6166(b)(10), as added by 2001 Act §572(a).

But see Curphey v. Comm'r, 73 T.C. 766 (1980), holding that taxpayer, a dermatologist, who also owned and managed six rental properties, was engaged in a trade or business under §280A.

Rev. Rul. 75-367, 1975-2 C.B. 472. See Ltr. Rul. 9212001 (June 20, 1991), which held that farm land removed from commercially productive purposes pursuant to the Federal Conservation Reserve Program was still part of decedent’s active trade or business of farming within the meaning of §6166. Also see Ltr. Rul. 9214010 (December 23, 1991), which disregarded the decedent’s royalty interest in gas and oil production on his ranch from the determination of the estate’s eligibility under §6166.


See Ltr. Rul. 8244003 (May 1, 1982).


See, e.g., Ltr. Ruls. 8829013 (April 15, 1988) and 8452017 (September 17, 1984).


Ltr. Rul. 9309015 (December 1, 1992).


Ltr. Rul. 9635004 (May 15, 1996); see also Ltr. Rul. 200006034 (November 12, 1999).

Ltr. Rul. 9801009 (September 26, 1997).

Ltr. Rul. 9832009 (May 6, 1998); see also Ltr. Rul. 200114005 (December 15, 2000).

§6166(a)(3).

§6166(a)(3); Reg. §20.6166-1(b)(6). Reg. §20.6166-1(b)(4) requires that a proper election must indicate the number or amounts of installments; however, in Ltr. Rul. 8142014 (May 21, 1981), an election was deemed valid although such information was not included. The election was presumed to be for the maximum time, payable in 10 equal installments beginning 5 years after the time fixed for filing the return.

§6166(f)(4).

The estate tax return is due within 9 months after the date of the decedent’s death. §6075. Upon a showing of good cause, an extension of time for filing such return may be granted. However, unless the executor is out of the country, the extension may not be for more than 6 months. Reg. §20.6081-1(a).

§§6601(j)(2)(A)(i) and 6601(j)(2)(B), as amended by 97 Act §503(a).


§6601(j)(1)(B), as amended by 97 Act §503(a).

§2053(c)(1)(D), as amended by 97 Act §503(b)(1).


§6161(a)(2).
Reg. §20.6161-1(a)(1), Examples (1) through (4).

Regs. §§20.6161-1(d) and 20.6165-1(a).