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Valuation Issues in Intra-Family Transfers

Louis A. Mezzullo

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Richmond, Virginia

(October 8, 1998)
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I. INTRODUCTION

A. Current Environment.

1. After the publication of Rev. Rul. 93-12, 1993-1 CB 202, the public press began to tout the benefits of using family limited partnerships to achieve significant reductions in the value of family-held assets for federal transfer tax purposes.

   a. The ability to reduce the value of otherwise liquid assets, such as marketable securities, by allegedly as much as 40 to 50 percent, seemed almost too good to be true.

   b. Responsible estate planning attorneys had used family limited partnerships for years to achieve many nontax objectives of their clients, while at the same time achieving transfer tax savings because of lack of marketability and minority interest discounts.

   c. However, family limited partnerships have become almost a panacea for every estate planning problem and are being used as a death-bed planning technique to achieve purported significant tax savings by establishing the entity months, and even days, before the client's expected death.

2. Before the publication of Rev. Rul. 93-12, the Internal Revenue Service (the Service) had sought both through the administrative process and by legislation to restrict the ability to achieve a minority interest discount when the entity was controlled by one family.

   a. Rev. Rul. 81-253, 1981-2 CB 187, had disallowed a minority interest discount in the case of a family-controlled corporation, but the courts consistently rejected this position.
b. In 1987, the Service was almost successful in statutorily eliminating minority interest discounts in family-controlled entities, but accepted I.R.C. § 2036(c) in its place.

(1) I.R.C. § 2036(c) was replaced in 1990 by Chapter 14.

c. With the plethora of family limited partnerships and LLCs being created today solely, at least in the eyes of the Service, for transfer tax avoidance purposes, the Service and the Treasury may go back to Congress to seek a statutory solution.

d. In the meantime, the Service has stepped up its scrutiny of family limited partnerships.

B. **General Principles.**

1. If there is to be a transfer tax, valuation is a key factor.

a. The tax will be determined by multiplying the tax rate times the value of the asset being transferred.

b. The tax rate itself presents no conceptual problem.

c. The valuation of the assets to be taxed, however, can present a problem.

d. Even in a case of marketable securities for which readily available market quotations are available, a transfer of a significant block may require a reduction in value because a significant number of shares of one issuer may not be tradeable at the otherwise quoted price.

e. In the case of nonmarketable assets, including interests in entities that may hold marketable assets, there is even more difficulty in arriving at the appropriate value for transfer tax purposes.

f. The Internal Revenue Code does not contain a definition of value for transfer tax purposes, although it contains a number of special rules that deal with value, such as I.R.C. § 2032A, providing for special valuation for real property used in a farm or closely-held business, and the special valuation rules under Chapter 14.

g. However, the regulations do provide a definition of value, i.e., what a willing buyer would pay to a willing seller, neither being under
any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts. Treas. Reg. § 20.2031-1(b).

h. Trying to determine what a willing buyer would pay a willing seller is not a simple matter, as demonstrated by the large number of cases involving valuation issues.

2. While all would agree that value is a key element in a transfer tax system, how value is determined can affect the integrity of the system or the ability to pass a family-held business to the next generation.

a. It should be axiomatic that the transfer tax system should not disfavor family-owned enterprises over publicly-owned enterprises.

(1) A share of stock in a publicly traded company has already been discounted by the free market because of lack of control.

(2) Such an interest is not entitled to a lack of marketability discount since by definition it is marketable.

b. On the other hand, if an interest in a family-held business is overvalued, the family will be paying more in transfer taxes than the corresponding owner of a publicly traded business would be paying for making the same transfer.

c. However, a family in control of a business has the ability to exercise or fail to exercise rights in a way that serves to reduce the value of interests held by older family members and to shift future increases in value to younger family members.

d. This ability to shift value transfer tax-free from the older generation to the younger generation may jeopardize the integrity of the transfer tax system.

3. The attempt to balance the desire to maintain the integrity of the system and the goal to treat family-controlled enterprises fairly creates the tension between the Service and the taxpayer.

a. This tension has spilled over into areas that do not involve "family-controlled enterprises," but rather family-owned investments, and in particular, liquid investments such as marketable securities.
4. The balance of this outline discusses some of the valuation issues that arise when family limited partnerships and LLCs are used for estate planning purposes.

   a. There is a legitimate place for family limited partnerships and LLCs in family planning, even in connection with the transfer of liquid assets from one generation to another.

   b. Even if the transfer tax system were eliminated tomorrow, wealthier clients would still be well-advised to use family limited partnerships and LLCs to achieve a number of nontax objectives.

II. VALUATION ISSUES: IN GENERAL

   A. Introduction.

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

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

         b. If instead the older family member transferred the $1,000,000 worth of IBM stock to an LLC and received all the LLC interest in exchange (assuming the LLC is formed in a state that recognizes a single-member LLC) and he or she then gives a ten percent interest in the LLC to the younger family member, the value of the gift for gift tax purposes may be less than $100,000.

         c. How much less will depend on the lack-of-control and lack-of-marketability discounts a business appraiser would attribute to a ten percent interest in an LLC owning IBM stock worth $1,000,000.

   2. A lack of control discount, also referred to as a minority interest discount, is appropriate when valuing an interest in an entity that does not give the holder of the interest the right to decide when distributions of earnings will be made, when the entity will be liquidated, and other issues that affect the financial benefits of interest ownership.
a. In an operating business, lack of control may also mean the interest holder will not be assured of being an officer or employee of the entity.

b. In the context of a family limited partnership or LLC, which usually involves passive investments, the lost opportunity to be an employee of the entity may not be important.

3. Until the Service issued Rev. Rul. 93-12, 1993-1 C.B. 202 in 1993, it had taken the position that a lack of control or minority interest discount was not appropriate in valuing an interest in an entity controlled by a family.

a. This position, which was originally set out in Rev. Rul. 81-253, 1981-2 C.B. 187, was rejected by the courts when challenged by taxpayers. See, e.g., Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982); Est. of Bright v. U.S., 658 F.2d 999 (5th Cir. 1981); Est. of Andrews v. Comr., 79 T.C. 938 (1982).


(1) Ultimately, legislators chose to enact instead § 2036(c), causing the value of a decedent's gross estate to include the value of property transferred during life by a decedent holding a substantial interest in a business, if such transfer represented a disproportionate share of the potential appreciation in the enterprise. H.R. REP. NO. 100-391, at 661, enacted by Pub. L. No. 100-203, tit. X, § 10,402(a), 101 Stat. 1330-431 (1987).


c. Although the proposal did not pass, the fact that Congress thought a statutory fix was necessary to eliminate minority discounts in family-controlled entities manifested its apparent belief that without such a statutory provision, minority interest discounts would otherwise be appropriate in family-controlled entities.
4. In Rev. Rul. 93-12, 1993-1 C.B. 202, which involved a gift by a 100 percent shareholder of a corporation of 20 percent of his stock to each of his five children, the Service ruled that the family's control of the entity would not be considered in valuing the 20 percent interests.


b. The next year, however, the Service seemed to retract some of what it had given when it ruled in a technical advice memorandum (TAM) that a swing vote premium was applicable when valuing a block of stock transferred to a family member if the block of stock enabled the transferee to join with another related owner of an interest in the entity to form a majority interest. TAM 9436005 (May 26, 1994).

(1) Under the facts in the TAM, the sole shareholder/taxpayer had transferred a 30 percent block of stock to each of three children, so that any two of the children could combine to form a majority interest.

(2) The ruling was based on *Estate of Winkler v. Comr.*, T.C.M. 1989, 231, in which the Tax Court found that a ten percent block of voting stock had special characteristics that enhanced its value when 40 percent of the stock was owned by the transferor's family and 50 percent by members of another family.

5. As will be discussed below, beginning in 1997 the Service began also to challenge lack of control and lack of marketability discounts in situations involving transfers just before the transferor died, particularly where the transfers were carried out by persons acting in a fiduciary capacity on behalf of the transferor. See *Est. of Schauerhamer v. Comr.*, T.C.M. 1997-242; see also TAM 9736004 (June 6, 1997); TAM 9735003 (May 8, 1997); TAM 9730004 (Apr. 3, 1997); TAM 9725002 (Mar. 3, 1997); TAM 9723009 (Feb. 24, 1997); TAM 9719006 (Jan. 14, 1997).
a. It is likely that some of the taxpayers involved in the TAMs will challenge the Service's position in court.

b. It is noteworthy that the Clinton administration's tax proposals for fiscal year 1999 included a provision that would deny valuation discounts for interests in a family-controlled entity for transfer tax purposes to the extent that the entity held passive investments. The Green Book, Feb. 1998, Department of the Treasury, p. 129; also found in General Explanation of the Administration's Revenue Proposals, Doc. 98-4793 Tax Notes Today 183 (Feb. 3, 1998).

6. A lack of marketability discount takes into account the fact that an owner of an interest in a nonpublicly traded entity will have more difficulty than an owner of a publicly traded entity in finding a willing buyer and, in order to sell the interest, may incur expenses, such as legal, accounting, and syndication fees.

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

b. However, there are situations in which publicly traded stock may not be marketable in the hands of a particular holder because of federal or state securities laws.

c. A business appraiser will often use the resulting reduction in value of such restricted stock that is otherwise publicly traded as a measure of the appropriate lack of marketability discount to apply when valuing nonpublicly traded stock.

7. The flip side of a lack of control discount is a control- or swing-vote premium.

a. In an operating business, a holder of a majority interest may be able to derive greater financial benefits from the business than a minority owner.

b. However, a majority interest in an entity in which the value of the underlying assets exceeds the value of the entity as a going concern should not be entitled to any premium.

(1) If the holder of the majority interest caused a liquidation of the entity of his or her interest in the entity, he or she
would be entitled to receive no more than his or her pro rata share of the liquidation value of the assets of the entity.

(a) In this case, the fact that he or she controls the timing of the liquidation of the entity simply eliminates the reason for a discount for lack of control, but does not enhance the value of the interest over its pro rata share of the value of the underlying assets.

(2) The same analysis applies to an interest that could be treated as representing a swing vote.

(a) The fact that the holder of such an interest could combine with another owner to gain control of the entity does not put that person in a better position than a person who owns a majority interest to begin with.

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

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

9. In most estate planning situations involving real estate and other passive investments, including marketable securities, the value of the underlying assets are usually worth more than the value of the entity as a going concern.

a. Therefore, a restriction on the right of an owner to cause a liquidation of the entity or to have his or her interest redeemed at a price equal to a pro rata share of the value of the entity's assets will be important in ensuring that the interest is entitled to a lack of control discount, assuming the restriction is not disregarded for federal transfer tax purposes.

B. Valuing Interests Held in Specific Entities.

1. Corporations.

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

(1) For example, the ownership of more than two-thirds of the voting stock is worth more than the ownership of more than 50 percent of the voting stock if the owner of the former but not the latter can cause a liquidation of the corporation without the approval of other shareholders.

(2) Furthermore, the ownership of more than 50 percent of the voting stock is worth more than the ownership of a lesser amount if the owner can thereby control the election of the corporation's board of directors.

b. If the value of the underlying assets of the corporation exceeds the going concern value, there should be no premium applied to a majority or controlling interest.

2. Limited Partnerships.

a. In the case of a limited partnership, valuation issues will differ for general and limited partners.
(1) An individual who owns only a limited partnership interest will have no right to participate in the management of the partnership, regardless of how much of an interest he or she holds.

(a) For example, in a limited partnership with a one percent general partner and a 99 percent limited partner, the general partner has the sole legal right to control the day-to-day affairs of the partnership.

(b) However, as a practical matter, if an individual owned 99 percent of the partnership interests as a limited partner, he or she may be in a position to exercise effective control over the one percent general partner.

(c) As the limited partner's percentage of the partnership declines, his or her effective control may also diminish.

(2) A limited partner in a limited partnership, depending upon state law, may also not have a right to have his or her interest redeemed until the end of the term of the limited partnership as set forth in a certificate of limited partnership.

(a) Setting such a term in the certificate of limited partnership could therefore trigger a lack of control discount for limited partnership interests.

(b) There is a possibility, though, that the Service could view the term as an "applicable restriction" under I.R.C. § 2704(b) (although this would be an extreme expansion of the section's reach) and ignore it for valuation purposes under Subtitle B of the Code.

(c) Some states have avoided this issue by specifically depriving a limited partner of a right to withdraw from the partnership, thereby ensuring that the restriction will be factored into the limited partnership interest's value. I.R.C. § 2704(b)(3)(B).
b. A general partner may be entitled to have his or her interest redeemed by the partnership at any time, although he or she may be subject to liability for a premature withdrawal.

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

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

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

3. LLCs.

a. In a member-managed limited liability company, a member will have control under the default rule of most state LLC statutes if he or she owns more than 50 percent of the membership interests entitled to vote.

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

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

c. Because in a manager-managed LLC, only the managers have a right to participate in the management of the LLC, a non-member-manager's interest in a manager-managed LLC should be worth proportionately less than a member-manager's interest.
C. **Business Appraisals.**

1. Regardless of the theoretical arguments that can be made for lack of control and lack of marketability discounts, a professional business appraisal should be obtained in every situation involving planning for transfers of interests in a family-controlled entity.
   
   a. It is highly unlikely that the lawyer preparing the operative documents and otherwise advising the family will be a qualified business appraiser.
   
   b. In many cases the family’s certified public accountant or other financial advisor will also not be a qualified business appraiser.

2. If the Service challenges the valuation and there is no business appraisal, the family may be forced to have the value of the interest determined many years after the transfer took place and may be subject to penalties in addition to gift taxes and interest.
   
   a. Although there can be no guarantee that the appraisal will withstand the scrutiny of a court, obtaining a professional business appraisal will put the family in a better position to defend any challenge by the Service to the lack of control and lack of marketability discounts taken.
   
   b. The latest version of I.R.S. Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, requires the taxpayer to indicate whether a valuation discount has been applied and to provide substantiation for the amount of the discount.

3. In some cases it will be necessary to obtain two appraisals, one for the assets held by the entity, such as real estate, and one to determine the value of an interest in the entity, which will depend upon a number of factors, including the size of the interest, the operative agreements, and the effect of state law on the rights of the owner.

D. **Marketable Securities.**

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


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

a. Before its amendment, I.R.C. § 731 generally provided that a partner did not recognize income when he or she received property in kind as a distribution from a partnership; instead, his or her basis in the distributed property was the lower of a partnership's basis for the property or his or her basis in the partnership.

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

c. Because marketable securities are now treated as cash when distributed to a partner, a partner may recognize taxable income when he or she receives marketable securities in a distribution. I.R.C. § 731(c)(1)(A).

d. Marketable securities will not be treated as cash if the partnership never held any assets other than marketable securities, indicating that Congress recognized that a partnership that owned only marketable securities was still a partnership for federal tax purposes. I.R.C. § 731(c)(3)(C)(i). See also H.R. REP. NO. 103-826(I), at 446 (1994), reprinted in 1995 U.S.C.C.A.N. 3773. ("It is acknowledged that certain partnerships are formed for the purpose of holding marketable securities for investment or for sale to customers.")

3. In addition, the Code defines a partnership as including a syndicate, group, pool, joint venture, or other unincorporated organization through or by
means of which any business, financial operation, or venture is carried on. I.R.C. § 761(a).

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

b. The Code allows an unincorporated organization to elect out of partnership treatment if the only purpose of the entity is investment and not the active conduct of a business. I.R.C. § 761(a).

c. Such an election would be unnecessary if an unincorporated organization holding nothing but marketable securities could not be treated as a partnership for federal tax purposes in the first place.

4. *Estate of Winkler v. Comr.* suggests that the Tax Court may find that a valid partnership exists for tax purposes, regardless of the type of assets it holds. T.C.M. 1997-4.

a. In *Winkler*, parents and five children purchased lottery tickets from time to time that were placed in a bowl in the family's home.

b. When a ticket purchased by the mother bore the winning number, the family applied for the winning proceeds as a partnership.

c. Because state law required that the partnership have a written agreement in order to receive the proceeds, the family went to an attorney to have a written agreement prepared.

d. The agreement provided that the mother and father were each entitled to 25 percent of any winning lottery proceeds and that the five children were each entitled to ten percent.

e. The Tax Court held that a partnership existed for federal tax purposes based on an analysis of the facts under the family partnership rules and the broad definition of partnership that appears in I.R.C. § 761(a).

5. Finally, Treasury Department regulations under I.R.C. §§ 701, 704, and 7701 include discussion of partnerships that are created solely for investment purposes. See Treas. Reg. §§ 1.701-1(a); 1.704-3(a)(3); and 1.761-2(a).
E. The Service's Challenge.

1. The TAMs.

   a. In 1997, the Service issued six TAMs in which it refused to recognize family limited partnerships, and in one case an LLC, for transfer tax purposes. TAM 9736004 (June 6, 1997); TAM 9735003 (May 8, 1997); TAM 9730004 (Apr. 3, 1997); TAM 9725002 (Mar. 3, 1997); TAM 9723009 (Feb. 24, 1997); TAM 9719006 (Jan. 14, 1997).

      (1) In the alternative, assuming that the entities were recognized for transfer tax purposes, the TAMs held that restrictions on transferability and liquidation would be disregarded for valuation purposes under I.R.C. § 2703 and, in five of the TAMs, I.R.C. § 2704(b).

      (2) From the facts presented, it may be inferred that the Service has chosen to focus on situations involving at least one of the following three factors:

         (a) Liquid assets, such as marketable securities, that were transferred to a limited partnership or LLC;

         (b) The transferor was elderly; or

         (c) The transfer was carried out by third parties (such as children) as agents under a power of attorney or as trustees.

   b. In each TAM, the Service claimed that the transaction should be treated as a single testamentary transaction and therefore disregarded for transfer tax purposes.

      (1) It based its decisions on the Tax Court case of *Estate of Murphy v. Comr.*, T.C.M. 1990-472, in which the court held that a minority interest discount was not applicable to stock of a closely-held corporation although the decedent owned less than 50 percent at her death.

         (a) At the urging of her accountant, Mrs. Murphy had transferred a 1.76 percent interest to her children 18 days before her death specifically to reduce her interest below 50 percent.
(b) In the TAM, the Service quoted the court's statement that "[a] minority discount should not be applied if the explicit purpose and effect of fragmenting the control block of stock was solely to reduce Federal tax." *Citing Knetsch v. U.S.*, 364 U.S. 361, 367 (1960), *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

(2) Understandably, the Service did not refer to the *Estate of Frank v. Comr.*, T.C.M. 1995-132, in which the Tax Court, on seemingly similar facts, held that a transfer of stock by the decedent's son acting under a power of attorney reducing the decedent's ownership interest from just over 50 percent of the corporation to 32 percent two days before his death was valid for transfer tax purposes, resulting in an overall 45 percent combined discount for lack of marketability and lack of control.

(a) The court in *Frank* stated that the motive for the transfer was irrelevant to the question of inclusion in the decedent's estate.

(b) Perhaps the facts in *Frank* can be distinguished from the facts in *Murphy*.

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

c. The Service's second argument in support of its position in the TAMs, which also would disregard the entity for transfer tax purposes, was based on I.R.C. § 2703(a)(2).

(1) It viewed I.R.C. § 2703 as applying to the entity itself, and not just to restrictions in an agreement or other document affecting an interest in the entity.
As a result, it posited, a transfer of an interest in the entity would be treated as a transfer of a fractional interest in the underlying assets held by the entity.

When applied to marketable securities, because the transfer became a transfer of the marketable securities themselves rather than an interest in the entity holding the securities, the Service noted that a discount from the fair market value of the marketable securities would not be appropriate.

When applied to real estate, because the transfer became a transfer of an undivided interest in the real estate, a fractionalization discount would be appropriate.

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

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

e. Finally, in all but one of the TAMs, the Service contended that under I.R.C. § 2704(b) any limitations on the right to liquidate the interests that were more restrictive than the state's default rule would be disregarded.

The Service's position that the entity be disregarded under I.R.C. § 2703 ignores the language of the statute, the Committee Reports indicating that Chapter 14 was not designed to eliminate minority discounts, and the principle that federal transfer tax applies to interests created under state law unless otherwise provided in the Code. H.R. Conf. Rep. No. 101-964 (1990) at 1137.

Consequently, while restrictions in the limited partnership or LLC operating agreement may be disregarded for valuation purposes under I.R.C. § 2703 if they do not
satisfy the three requirements of the statutory exception, the property interest should still be valued as a limited partnership interest or LLC interest and not as an undivided interest in the underlying assets.

(2) Whether I.R.C. § 2704(b) applies to cause restrictions on liquidation to be disregarded in valuing the interest depends upon state law and how the Service defines an applicable restriction.

(a) I.R.C. § 2704(b) can be avoided by forming the limited partnership or LLC in a state that has a default rule depriving a limited partner or a member of an LLC of the right to withdraw.

2. Schauerhamer.


(1) The decedent formed a separate limited partnership with each of her three children and transferred a substantial percentage of her interests in the limited partnerships to family members, using the annual exclusion to avoid taxable gifts.

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

(3) The Service once again argued that the limited partnership interests should be disregarded based on its I.R.C. § 2703 analysis.

(4) However, the Tax Court decided that the transferred interests should be included in the decedent's estate under I.R.C. §§ 2036(a) and 2038 and decided the case in favor of the Service without invoking I.R.C. § 2703.

(a) The Court found that there was an implied agreement that the decedent would retain the economic benefits of the property and, therefore, because the decedent had transferred property and
retained the right to enjoyment of the income from the property until her death, the transferred limited partnership interests were includible in her estate under I.R.C. § 2036(a)(1).

(b) The Schauerhamer case points out the importance of complying with all the formalities under state law and the terms of the operative agreements to ensure that the entity will be recognized under state law and the property transferred to the entity will not be includible in the transferor's estate under I.R.C. §§ 2036(a) and 2038.

III. SPECIAL VALUATION RULES

A. Introduction.

1. The special valuation rules contained in Chapter 14 of the Internal Revenue Code may apply to transactions involving family limited partnerships and LLCs.


(1) Under former I.R.C. § 2036(c), transferred property and interests in property were brought back into the transferor's estate if the transferor transferred a disproportionate share of the future appreciation to younger family members and retained rights to income or management.

(2) As interpreted by the Service, it potentially applied to almost every conceivable arrangement for passing property and interests in property to younger family members and required complex calculations to determine the amount ultimately included in the transferor's estate.

b. On the other hand, Chapter 14 applies special valuation rules to the initial transfer and provides for adjustments in taxable gifts or adjusted taxable gifts, either upon a later transfer of a retained interest or at the death of the transferor.
2. Although a detailed analysis of Chapter 14 is outside the scope of this outline, the following discussion deals with its application to transactions involving interests in family limited partnerships and LLCs.

   a. I.R.C. § 2701 applies special valuation rules to certain transfers of interests in corporations and partnerships (including LLCs treated as partnerships for federal tax purposes) and I.R.C. § 2702 applies special valuation rules to transfers of interests in trusts.

      (1) Both sections have the effect of reducing or eliminating any value of a retained interest in the entity and thereby increasing the value of the transferred interest for gift tax purposes.

   b. I.R.C. §§ 2703 and 2704(b) increase the value of transferred corporation or partnership interests by ignoring certain restrictions, options, or rights associated with such interests when valuing them for transfer tax purposes.

   c. I.R.C. § 2704(a) treats lapses of voting and liquidation rights in family-controlled corporations or partnerships as taxable transfers.

B. Transfers of Partnership and LLC Interests.

   1. I.R.C. § 2701 ignores the value of applicable retained interests in a partnership or LLC for purposes of determining the value of subordinate equity interests transferred to the transferor's spouse and descendants and spouses of descendants of the transferor and the transferor's spouse. I.R.C. § 2701(a)(1), (a)(3)(A), and (e)(1).

      a. Applicable retained interests are certain senior equity interests (i.e. equity interests that carry a preferred right to income or capital distributions) retained by the transferor and the transferor's spouse and ancestors and spouses of ancestors of the transferor or the transferor's spouse. I.R.C. § 2701(a), (b), and (e)(2); Treas. Regs. § 25.2701-3(a)(2)(ii).

      b. A senior equity interest is an applicable retained interest to the extent it gives the holder (1) an extraordinary payment right or (2) a distribution right (the right to receive distributions from the entity) if the transferor or a member of the transferor's family controls the entity. I.R.C. § 2701(c)(1)(A).
An extraordinary payment right is the right to put or call the interest (i.e., to force the entity to purchase the interest from the holder or to require the entity to sell an interest in the entity to the holder), to convert the interest into a subordinate equity interest, or to compel the liquidation of the interest (essentially a put right). I.R.C. § 2701(b)(1)(B); Treas. Regs. § 25.2701-2(b)(2).

The transferor or a member of the transferor's family (defined for this purposes as including descendants of the parents of the transferor or the transferor's spouse, as well as ancestors and spouses of ancestors of the transferor and his or her spouse) (I.R.C. § 2701(b)(2)(C)) controls an entity if any of them is a general partner in a limited partnership (or presumably a member-manager in a manager-managed LLC) or together they own 50 percent or more of the equity interests in the entity. I.R.C. § 2701(b)(1), (b)(2).

A distribution right does not include (i) a right to distributions with respect to any interest that is junior to the rights of the transferred interest, (ii) any liquidation, put, call, or conversion right, or (iii) any right to receive any I.R.C. § 707(c) guaranteed payment of a fixed amount. I.R.C. § 2701(c)(1)(B).

c. However, the value of distribution rights which are qualified payment rights are not ignored. I.R.C. § 2701(a)(3).

A qualified payment right is the right to receive a fixed amount or an amount based on a fixed interest rate from the entity at least annually, or, if the amount is not paid in the current year, to receive the accumulated unpaid amounts in subsequent years before other equity interest holders receive distributions from the entity. I.R.C. § 2701(c)(3), Treas. Regs. § 25.2701-2(b)(6).

(a) A holder of cumulative preferred stock has a qualified payment right.

Although a qualified payment right is valued at fair market value for purposes of determining the value of the initial transfer unless it is combined with an extraordinary payment right (Treas. Regs. § 25.2701-2(a)(4)), the entity's
subsequent failure to pay the qualified payment on a timely basis may result in an increase in the holder's taxable gifts if he or she transfers a qualified payment right during life or in the taxable estate if the right is held at death. Treas. Regs. § 25.2701-4(a), and (c).

2. Certain payment rights fall outside the definition of distribution rights completely and thus are not ignored in valuing the applicable retained interest.

   a. These rights include mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under I.R.C. § 707(c), and nonlapsing conversion rights. Treas. Regs. § 25.2701-2(a)(4).

   b. A guaranteed payment right, which entitles the holder to receive a fixed amount at a specified time, is also valued at fair market value when determining the value of a transferred subordinate equity interest. Treas. Regs. § 25.2701-2(b)(4)(iii).

      (1) For example, an individual has a guaranteed payment right if he or she is entitled to receive $2,000 a year from the entity for his or her lifetime.

3. The effect of I.R.C. § 2701 is to reduce the value of interests older family members continue to hold and increase the value of interests transferred to younger family members by applying the subtraction method of determining the value of a transferred interest when I.R.C. § 2701 applies.

   a. Under this method, the value of any equity interests retained by the older family members, disregarding applicable retained interests and distribution rights that are not qualified payment rights, is subtracted from the value of all family-held interests in the entity.

   b. The remainder is the value assigned to the subordinate equity interests and other equity interests held by the family in the entity. Treas. Regs. § 25.2701-1(a)(2); See also Treas. Regs. § 25.2701-3 for specific methodology.

   c. Because in most cases it is the subordinate equity interests that have been transferred to younger family members, the amount of taxable gifts by the older transferring family members is increased by the same amount that the value of their retained equity interests is reduced.
4. Transfer tax savings may be obtained by transferring to younger family members equity interests that will absorb the future growth in the entity's value.

a. For example, an older family member starting a new business with little initial value will incur a small taxable gift if he or she gives all the residual interests to younger family members and retains a senior equity interest that is valued at zero because it is not a qualified payment right.

(1) Any subsequent increase in value will inure to the younger family members without further gift tax consequences.

b. Likewise, a tax-free shift in value occurs if the value of a business increases at a rate that exceeds the discount rate used in determining the value of a qualified payment right or guaranteed payment right retained by the older family member.

(1) Although the value of the qualified payment right or guaranteed payment right will reduce the value of the taxable gift, any payments actually made will be included in the older family member's estate.

(2) In addition, any unpaid or late payments, compounded at the discount rate used to value the qualified payment right, will be included in the transferor's taxable gifts.

5. Nonetheless, in most situations the family can best achieve its tax and nontax goals by avoiding the application of I.R.C. § 2701 altogether.

a. I.R.C. § 2701 is not operative if there is only one class of equity interest in the entity, despite differences in voting rights, rights to manage the entity, or exposure to liability. Treas. Regs. § 25.2701-1(c)(3).

b. Only one class of entity will exist if distributions of operating revenue and liquidating proceeds are based on capital accounts and the capital accounts are maintained in a manner that reflects the financial investment of the owners in the enterprise from time to time, taking into account profits retained in the entity and losses allocated to the owners. Treas. Regs. § 25.2701-1(c)(3).

(1) For example, if Smith's capital account has a balance of $10,000 and the capital account balances of all the owners
is $100,000, Smith would receive ten percent of all distributions.

(2) To reflect the owner's financial investment in the entity, an owner's initial capital account should:

(a) Equal the fair market value of the owner's initial capital contribution;

(b) Be increased by any additional capital contributions, the owner's distributive share of the entity's profits, and the amount of any of the entity's liabilities that are assumed by the owner or that are secured by property distributed to the owner by the entity; and

(c) Be decreased by the amount of cash and the fair market value of any property distributed to the owner, the owner's distributive share of the entity's losses, and the amount of any liabilities of the owner that are assumed by the entity or that are secured by any property contributed by the owner to the entity.


(3) If there are any gifts to the entity by a person who is not an owner, the capital accounts of the owners should be increased on a pro rata basis to reflect the fair market value of the property.

(4) Finally, if an owner makes a nonpro-rata capital contribution to the entity or the entity makes a nonpro-rata distribution to an owner, the capital accounts of the owners should be adjusted to reflect the then fair market value of the assets held by the entity immediately before the capital contribution or distribution. Treas. Regs. § 1.704-1(b)(2)(iv)(d)-(f).

(a) The capital account of the contributor or the distributee is adjusted to reflect the fair market value of the property contributed or distributed. Treas. Regs. § 1.704-1(b)(2)(iv)(b).
6. If capital accounts are properly maintained, basing distributions on relative capital account balances of the owners will ensure that only one class of equity exists.

   a. In this regard, the regulations under I.R.C. § 2701 state that special allocations to satisfy specific requirements in subchapter K (the partnership taxation rules), such as the special allocation rules of I.R.C. §§ 704(b) and 704(c)(1)(A), will not create a second class of equity. Treas. Regs. § 25.2701-1(c)(3).

   b. In addition, such allocation of income, gain, loss, deduction and credit items will eliminate several other potential tax problems.

      (1) Allocation of tax items according to relative capital account balances will avoid the complex rules under I.R.C. § 704(b) dealing with the substantial economic effect of special allocations of tax items.

      (2) Also, the family partnership rules under I.R.C. § 704(e) require that the allocation of a partnership's income must be proportional to the capital interests, after allocating to a donor partner reasonable compensation for services he or she rendered to the partnership. Treas. Regs. § 1.704-1(e)(3).

      (3) Finally, maintaining one class of equity interest will avoid the possible triggering of a gift by an inadvertent lapse under I.R.C. § 2704(a), which can occur if an older family member loses the right to liquidate his or her retained subordinate equity interest because of a transfer of a senior equity interest to a younger family member.

C. Transfers of Interests in Trusts.

1. I.R.C. § 2702 applies special valuation rules to transfers of interests in trusts to, or for the benefit of, a member of the transferor's family where the transferor or an applicable family member retains an interest in the trust.

   a. The value of any such retained interest is zero unless it is a qualified interest, in which case its value is determined using 120 percent of the federal mid-term rate. I.R.C. §§ 2702(a)(2), 7520.
b. Member of the family is defined in I.R.C. § 2704(c)(2) as the transferor's spouse, any ancestor or lineal descendant of the transferor or the transferor's spouse, any sibling of the transferor, or any spouse of such ancestor, descendant or sibling. I.R.C. § 2702(e).

c. Applicable family member has the same definition for purposes of I.R.C. § 2702 as it does for I.R.C. § 2701, i.e., the transferor's spouse, any ancestor of the transferor or the transferor's spouse, or any spouse of such ancestor. I.R.C. § 2702(a)(1).

d. A qualified interest includes an interest consisting of the irrevocable right to receive a fixed amount payable at least annually (a "qualified annuity interest"). I.R.C. § 2702(b)(1); Treas. Regs. § 25.2702-3(b), and (d).

(1) A trust in which the transferor has retained a qualified annuity interest is referred to as a grantor retained annuity trust, or GRAT.

2. I.R.C. § 2702 does not directly affect the transfers of interests in family limited partnerships and LLCs.

a. In some cases, however, transferring limited partnership and LLC interests to a GRAT may allow older family members to transfer future growth in the value of the entity to younger family members without incurring substantial gift tax if the value of the entity increases at a rate in excess of the I.R.C. § 7520 interest rate used to determine the value of the retained annuity interest for gift tax purposes.

b. Additionally, if the value of the entity interest transferred to the GRAT is discounted for lack of marketability and lack of control, the value of the interest transferred to the trust by the grantor for transfer tax purposes will be smaller than a pro rata share of the value of the underlying assets; consequently, the value of the gift, after reducing it by the value of the retained annuity interest, will be lower than if the underlying assets had been transferred directly to the GRAT.

(1) Note, however, that in at least one private letter ruling (PLR) approving the terms of a GRAT, the taxpayer represented that no discount was taken in connection with
the transfer of an interest in a limited partnership to the GRAT. PLR 9707027.

(2) This representation may indicate that the Service took the position that the transfer tax leveraging allowed through the use of a GRAT may not be combined with lack of control and lack of marketability discounts.

c. Example. Assume the sole owner of an LLC having a fair market value of $4,000,000 transfers a 40 percent interest in the entity to a GRAT, retaining the right to an annuity equal to eight percent of the initial value of the assets in the trust, payable for 15 years. Assume that 120 percent of the federal mid-term rate is eight percent. Assume also that the value of the minority interest held by the trust is $960,000, reflecting a 40 percent combined minority and lack of marketability discount ($1,600,000 [40 percent of $4,000,000] x 60 percent), and that the annual payment is $76,800. Note that the annuity payment, which is eight percent of the discounted value of the minority interest, represents only 4.8 percent of the actual, undiscounted value of the interest. Therefore, any increase in the value of the LLC greater than 4.8 percent will shift to the remainder beneficiary transfer-tax free. On the other hand, if the interest held in trust were valued at its full pro rata share of the fair market value of the LLC, the LLC would have to increase in value at a rate greater than eight percent to achieve a similar transfer-tax free shift in value. Consequently, more value can be shifted tax-free to younger family members if the transfer tax value of the property transferred to the GRAT can be discounted for lack of control and lack of marketability.

D. Rights or Restrictions.

1. Under I.R.C. § 2703, the value of any property is determined for transfer tax purposes without regard to any right or restriction relating to the property.


   b. In fact, it is directed at any option, agreement, or other right to acquire or use the property at a price less than the fair market
value of the property (determined without regard to the option, agreement, or right) or any restriction on the right to sell or use the property. I.R.C. § 2703(a).

c. Such rights or restrictions include restrictions on the owner's right to require the entity to buy his or her interest at a reasonable price or on the right to transfer the owner's interest to third parties without unreasonable restrictions.

d. The Service has attempted to expand the reach of I.R.C. § 2703 by arguing that the entity itself may be disregarded under I.R.C. § 2703, so that a transfer of an interest in the entity, either during lifetime or at death, is treated as a transfer of an interest in the underlying assets held by the entity. See TAM 9736004 (June 6, 1997); TAM 9735003 (May 8, 1997); TAM 9730004 (Apr. 3, 1997); TAM 9725002 (Mar. 3, 1997); TAM 9723009 (Feb. 24, 1997); and TAM 9719006 (Jan. 14, 1997).

(1) Accordingly, the Service would not apply a discount to a transfer of an interest in an entity holding marketable securities and would allow only a fractionalization discount, presumably less than a combined lack of control and lack of marketability discount, to a transfer of other kinds of investments, such as real estate.


(3) If the entity is valid under state law, the interest to be valued for gift and estate tax purposes must be the interest in the entity and not an interest in the assets of the entity.

2. There are two exceptions to I.R.C. § 2703, one statutory and one regulatory.

a. Under the regulatory exception, a right or restriction on the interest's value is not ignored if the family owns less than 50 percent of the value or voting rights in the entity. Tres. Regs. § 25.2703-1(b)(3).
b. Under the statutory exception, a right or restriction that satisfies the following three requirements will not be disregarded:

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

Treas. Regs. § 25.2703-1(b)(1).

c. Consequently, a restriction that is commercially reasonable should not be disregarded when valuing an interest in a family-controlled business.

E. **Lapsing Voting and Liquidation Rights.**

1. I.R.C. § 2704(a) treats the lapse of a voting or liquidation right as a taxable transfer for gift, estate and generation-skipping transfer tax purposes, but only if the individual holding such right and his or her family controls the entity both before and after the lapse. I.R.C. § 2704(a)(1).

   a. For purposes of I.R.C. § 2704, "member of the family" means the individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any sibling of the individual, and any spouse of such ancestor, descendant or sibling. I.R.C. § 2704(c)(2).

   b. Control is defined in the same manner as it is defined for purposes of applying special valuation rules under I.R.C. § 2701. I.R.C. § 2704(c)(1).

2. The value of the deemed transfer is determined by valuing all interests held immediately before the lapse by the individual, as if the lapsed voting or liquidation right still existed, and subtracting the fair market value of the same interests after the lapse (i.e., under normal valuation rules). I.R.C. § 2704(a)(2).
a. The pre-lapse value of the interests is measured immediately after the lapse, but as if the lapsed voting or liquidation right still existed, so as to take into account any loss in value attributable to factors other than the lapse itself. Treas. Regs. § 25.2704-1(d), (f).

b. For example, if the lapse occurs because of the death of the holder of the interest and the holder of the interest was a key employee, the reduction in the value of the interest may be partially attributable to the loss of the key employee and not entirely due to the lapse of the voting or liquidation right. See Treas. Regs. § 25.2704-1(f), Example 1.

3. The application of I.R.C. § 2704(a) can be avoided if there are no lapsing voting or liquidation rights to begin with.

a. However, depending upon the capital structure of the entity, a lapse may occur when interests in the entity are transferred, even though the voting and liquidation rights with respect to the transferred interests do not lapse. I.R.C. § 2704(b).

b. Under the regulations, if an older family member transfers a senior equity interest, such as a preferred partnership interest, to a younger family member and as a result loses the right to liquidate his or her retained subordinate equity interest, such as a residual partnership interest, the lapse of the right will be treated as a taxable transfer. Treas. Regs. § 25.2704-1(c)(1), (f), Examples 7 and 8.

c. This could occur, for example, if an older family member transfers a frozen partnership interest that would be considered a senior equity interest and retains a residual interest, and as a result reduces his or her partnership interest below that amount required to prevent a continuation of the partnership in the event of the withdrawal of a general partner.

(1) The transferring older family member may be a general partner in a limited partnership whose withdrawal from the partnership would be treated as a dissolution event, requiring the consent of all (or in some states a majority) of the remaining partners to continue the limited partnership.

(2) If the limited partnership interest transferred by the older member represented all his or her remaining limited partnership interest or reduced the transferor’s partnership
interest below a majority interest, then he or she could, depending upon state law, lose the right to cause a liquidation of the partnership by withdrawing as a general partner and voting not to continue the limited partnership.

(3) Consequently, the regulations would treat the transfer of the limited partnership interest in this case as a lapse of the general partner's right to liquidate.

4. In some cases, older family members may want to retain voting rights or management rights while they are alive, but want the rights to lapse upon their death so that younger family members receiving the interests pursuant to the older family member's estate plan will not succeed to the voting or management rights.

a. If the entity is structured with at least one other general partner or, in the case of an LLC, member-manager, the decrease in the value of the transferred interests at death because of the lapse of the management or voting right may not be significant, since before death the decedent did not have control as a result of the existence of the other general partner or member-manager.

b. Whether there was a lapse of a liquidation right would depend on whether the deceased general partner or member-manager also had a right to liquidate his or her interests.

(1) In the case of an LLC, state law dictates whether the withdrawal or death of a member causes a dissolution event under its default rule.

(2) In the case of a limited partnership, if the partnership agreement provided that the partnership would not dissolve upon the withdrawal or death of a general partner if another general partner remained, there would be no lapse of a right to cause a dissolution under state law.

(a) However, a provision in the limited partnership agreement providing for the continuation of the limited partnership in the event of a general partner's withdrawal if there is at least one other general partner may be viewed as an applicable restriction under I.R.C. § 2704(b), and as such would be ignored for purposes of determining
whether there has been a lapse of the right to liquidate.


(c) Such a provision would more closely resemble the type of applicable restriction covered by I.R.C. § 2704(b).

(d) On the other hand, if under state law the default rule is a continuation of the limited partnership in the event of a withdrawal of a general partner when there is at least one other general partner absent a contrary provision in the limited partnership agreement, I.R.C. § 2704(b) should not apply.

F. Applicable Restrictions.

1. Under I.R.C. § 2704(b), a restriction on the right of an owner to cause a liquidation of the entity or of his or her interest in the entity will be disregarded as an "applicable restriction" for purposes of determining the value of an interest transferred to a member of the transferor's family if the entity is controlled by the family before the transfer and the family can remove the restriction, or the restriction will lapse, after the transfer.

   a. However, a limitation on the right of an owner of an interest in an entity to cause the entity to be liquidated or to have his or her interest liquidated is not an applicable restriction if the limitation is no more restrictive than the state's default rule. I.R.C. § 2704(b)(3)(B); Treas. Regs. § 25.2704-2(b).

   b. Therefore, a restriction on the right of a limited partner or a member of an LLC to withdraw from the entity and receive value for his or her interest is not an applicable restriction if state law does not give the limited partner or member such a right at all.
(1) The fact that the family could override the state's default rule and allow a limited partner or a member to withdraw and receive value for his or her interest does not change this result.

(2) If the regulations under I.R.C. § 2704(b) had provided that an applicable restriction is any restriction that could be overridden by the family regardless of the default rule under the applicable state law, then the holder of shares in a family-controlled corporation would be treated as having the right to put his or her interest to the corporation and receive fair market value for his or her interest, since the family could always agree to such a transaction.

(3) Fortunately, the regulations, consonant with the policy expressed in the Committee Reports that Chapter 14 was not designed to eliminate minority interest discounts, look to the state's default rule for purposes of determining whether an applicable restriction exists. H.R. Conf. Rep. No. 101-964 (1990) at 1137.

2. A general partner in a general or limited partnership always has the right to withdraw and receive value for his or her interest.

   a. Under the Uniform Partnership Act, the withdrawal of a general partner also causes the dissolution of the partnership, even though the remaining partners can always agree to continue the business of the former partnership by forming a new partnership. Unif. Partnership Act § 801(1), Comment 1 (Supp. 1998).

   b. Under the Revised Uniform Partnership Act (RUPA), in a partnership that has a definite term or that is organized for a specific undertaking, a majority of the remaining partners may agree to continue the partnership after an event of dissolution, but the general partner who withdraws is presumably still entitled to receive value for his or her interest. See Unif. Ltd. Partnership Act § 801 (1985).

   c. A general partner withdrawing from either a general or limited partnership may be subject to liability for a premature withdrawal, but the potential liability for a premature withdrawal would be disregarded as an applicable restriction since it would not be pursuant to the state's default rule but based on the terms of the partnership agreement.
3. If a general partner withdrawing from a limited partnership also owns a limited partnership interest, he or she may also have the right to have his or her limited partnership interest liquidated.

   a. If under state law the withdrawing partner has the right to withhold consent as a limited partner to the continuation of the limited partnership even though it was his or her withdrawal that caused the dissolution event, and state law requires the consent of all the remaining partners to continue the partnership, he or she would have a right to withhold consent and cause a dissolution of the limited partnership.

      (1) He or she would then be entitled to receive value for his or her limited partnership interest in addition to his or her general partnership interest.

   b. On the other hand, if only those limited partners holding a majority-in-interest were required to consent to the continuation of the limited partnership and the withdrawing general partner did not hold a majority-in-interest of the limited partnership interests, then he or she would not be able to cause a dissolution of the partnership and would not be able to have his or her limited partnership interest liquidated.

   c. Also, if only the nonwithdrawing limited partners were required under state law to consent to the continuation of the limited partnership, a withdrawing general partner could not cause the dissolution of the limited partnership because he or she would not have the right to refuse consent.

   d. Furthermore, in most states a limited partnership agreement may provide that if there is more than one general partner, the withdrawal of one of the general partners does not cause a dissolution event.

      (1) As discussed above, such a provision may be treated as an applicable restriction and therefore disregarded for purposes of valuing a limited partnership interest held by a general partner at death.

      (2) Consequently, the value of the deceased general partner's limited partnership interest would presumably be based on what he or she would have been entitled to receive under state law if he or she withdrew from the limited partnership.
4. The potential problems caused in a limited partnership by the right of a general partner to withdraw at any time under state law is avoided in an LLC formed in a state that does not give a member a right to withdraw and has a default rule that provides for continuity of life.

a. In this situation, an interest in an LLC will have the same characteristics as shares of stock in a corporation for purposes of I.R.C. § 2704(b).

b. Under every state's corporation law, a shareholder has no right to demand that the corporation redeem his or her stock and cannot unilaterally cause a dissolution of the corporation, unless he or she owns a certain percentage of the shares (in most states, more than two-thirds). See, e.g., Ala. Code § 10-2B-14.02(f) (1997); Va. Code Ann. § 13.1-742(E) (Michie 1997).

c. If a state's LLC statute requires unanimous consent to dissolve the LLC, an interest in an LLC may be entitled to a larger discount than shares in a corporation since dissolution of the LLC will be less likely.

5. Although I.R.C. § 2704(b) may be avoided if the right entity is formed in a state that denies a member the right to withdraw and provides continuity of life as the default rule, the Service has taken the position that a restriction on an owner's right to have his or her interest liquidated must also pass muster under the I.R.C. § 2703 exceptions before it will be factored into the valuation of the interest.

a. In other words, even though the restriction is not an applicable restriction under I.R.C. § 2704(b), the restriction will still be disregarded for transfer tax valuation purposes if it is not commercially reasonable. I.R.C. § 2704(b)(3)(A). See, e.g., TAM 9736004, TAM 9730004, and TAM 9725002.

b. However, a solid argument can be made that in any closely-held business entity, the owners do not give one another the right to require the entity to redeem his or her interest at any time at a value approaching the fair market value of the interest.

(1) Usually an owner has the right to have his or her interest redeemed upon certain stated events and the value is not necessarily based on the fair market value, but may be based on the ability of the entity to pay for the redeeming
owner's interest without jeopardizing the financial viability of the entity.

(2) Unfortunately, the courts probably will have to decide what restrictions are reasonable.

6. If someone other than a family member can prevent the withdrawal of another member, the restriction will not be treated as an applicable restriction under I.R.C. § 2704(b). Treas. Reg. § 25.2704-2(b).

   a. Therefore, another way of avoiding I.R.C. § 2704(b) would be to add a nonfamily member, such as a charitable organization, as an owner of the entity, and requiring the consent of all partners or members in order for a partner or member to withdraw.

   b. In the family-owned business context, adding a nonfamily member as an owner may not be palatable.

7. It could be argued that an interest in a limited partnership or LLC should be valued as an assignee's interest rather than an interest possessing all the rights of a limited partner or member, because there is no certainty that a transferee of the interest would be treated as a limited partner or member.

   a. All states currently require the consent of some or all the other owners before a transferee becomes a partner or member.

   b. An assignee would have only the right to receive distributions that the transferor would have received, but no other rights, such as any right to have his or her interest liquidated.

IV. FRACTIONAL INTEREST DISCOUNTS

A. Introduction.

1. A fractional interest discount should reduce the value of an undivided interest in an asset, such as real estate, that cannot be readily severed without any loss in its value.

2. A fractional interest discount differs from a lack of control or minority interest discount.

   a. A lack of control or minority interest discount reflects the lack of control an owner of an interest in an entity has over the day-to-day decisions concerning the entity's activities or investments,
distributions of cash or other property, and the liquidation of the entity.

(1) The owner may hold less than a majority of the voting or management rights or may be a limited partner in a limited partnership or hold some similar type of ownership interest that excludes the owner from participating in the decision-making process.

b. A fractional interest discount reflects the lack of any mechanism for making decisions, thus requiring unanimous agreement among the owners to make any decisions, with the ultimate decision-maker the court in a partition suit.

3. In early cases, like Propstta v. Com., 82-2 USTC ¶ 13,475, 680 F.2d. 1248 (CA-9), little or no empirical evidence was offered by either the Service or the taxpayer to support a particular discount.

a. The Tax Court adopted a 15 percent discount as a compromise between the Service's and the taxpayer's positions.

b. In Mooneyham v. Com., CCH Dec. 47,303(M), 61 T.C.M. 2445 (1991), Judge Cohen expressed her dissatisfaction with this approach, but applied the 15 percent discount nonetheless.

B. Recent Developments.

1. The Service's Position.

a. In TAM 9336002, the Service ruled that the cost of partition was the appropriate measure of the discount for an undivided interest.

(1) A partition could involve a physical partition, where the property is actually divided into separate parcels and then distributed to the owners, or a sale of the property, followed by a distribution of the proceeds to the owners in proportion to their ownership interests.

(2) Which form of partition is used depends upon whether the real estate is capable of being evenly divided among the owners so that each owner receives an interest of equivalent value.
(a) In most cases, because of the nature of the real estate, a physical division is not possible; e.g., an office building would be difficult to divide.

b. The costs involved in a partition suit vary from six percent to 12 percent of the value of the property, depending upon the state, and the type of property involved.

2. Recent Tax Court Decisions.


(1) A 30 percent discount was applied.

(2) The court applied a combined 20 percent minority discount and ten percent lack of marketability discount, after holding that the transfers were transfers of fractional interests in real estate and not partnership interests because of the formalities in the case; i.e., the partnership was created after the real estate was transferred to family members, apparently to avoid local taxes on the transfer.

(3) The court also rejected the Service's position that no discount was available because the owners were family members, citing Propstra v. United States, Estate of Bright v. United States, Estate of Andrews v. Com., and Estate of Lee v. Com., 69, T.C. 860 (1978).


(1) A 20 percent discount was applied.

(2) The court noted the partition would involve substantial legal costs, appraisal fees, and delay, and any partition would require an agreement among interest owners as to the relative value of the land.


(1) A 26 percent discount was applied.

(2) The court determined the discount by taking into account the delay a partition suit would involve, the present value of the income that would be generated from the property
during the delay, and the present value of the proceeds as a result of the partition suit, and deducted from these amounts the present value of the partition costs.


(1) A 44 percent discount was applied.

(2) The court adopted the taxpayer's contention that a 44 percent discount should be applied to value undivided one-half interests in real estate that were gifted during the decedent's lifetime and that passed at the decedent's death.

(3) The court rejected the Service's position that the expert for the taxpayer should be disregarded because he was not a real estate appraiser, noting that he was an experienced business appraiser who had given expert opinions in valuing fractional interests in partnerships, businesses, and real property. The court noted that he had considered the time and expense of selling the real property in that particular market, and appropriately considered all relevant facts and gave a reasonable explanation of the discount he applied to the property interest at issue.

C. **Analyzing the Fractional Interest Discount.**


   a. Owners of undivided interests have unlimited liability.

   b. Undivided interests require unanimous consent for all decisions.

   c. It is difficult to use an undivided interest as collateral for a loan because creditors are reluctant to accept such an interest as collateral.

   d. Each owner has the right to use the property, subject to the rights of the other owners, although profits, if any, are shared and distributed in proportion to ownership interests.

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

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

4. In a more recent study, the average discount in 24 transactions was 47
percent. See Humphrey and Humphrey, "Unsyndicated Partial Interest

V. ESTABLISHING THE VALUE OF A FAMILY-HELD BUSINESS FOR ESTATE TAX
PURPOSES

A. Introduction.

1. The value of an asset for federal estate tax purposes is its fair market
value.
   a. Fair market value is defined as the price a willing buyer would pay
a willing seller for the property or interest in property, both with
reasonable knowledge of the relevant facts and neither under a
compulsion to sell or to buy. Treas. Reg. § 20.2031-1(b).

2. Under the regulations and the case law developed before the adoption of
Chapter 14, the purchase price determined under a buy-sell agreement can
fix the value of an interest in a closely-held business if the following four
requirements are satisfied:
   a. The price must either be fixed or determinable pursuant to a
formula contained in the agreement.
   b. The decedent's estate must be obligated to sell at death at the fixed
price.
(1) This can be accomplished either by giving the entity or the other owners an option to buy the deceased owner's interest or by using a mandatory buy-sell arrangement.

c. The restriction must apply during the deceased owner's lifetime. Treas. Reg. § 20.2031-2(h).

(1) At a minimum, the other owners must have a right of first refusal to buy the interest at the fixed or determinable price before the owner can sell the interest to a third party. Estate of Lionel Weil, 22 T.C. 1267 (1954).

(2) This requirement may not be satisfied if the owners may transfer their interests to relatives or other owners by gift during life unless the donees become subject to the same restrictions.

d. The agreement must be a bona fide business arrangement and not a device to pass the interest to the natural objects of the deceased owner's bounty without full and adequate consideration in money or money's worth. Treas. Reg. § 20.2031-2(h); Rev. Rul. 59-60, Sec. 8, 1959-1 C.B. 237.

(1) This requirement should be met if the price under the agreement is equal to the fair market value of the interest at the time the agreement is originally executed.

3. In Rudolph v. U.S., 93-1 USTC ¶ 60,130 (S.D.IN., decided February 5, 1993), which dealt with a buy-sell agreement not subject to I.R.C. §2703 because it predated the effective date of that section, the district court reviewed the fourth requirement in some detail.

a. In holding that the purchase price under the agreement controlled the estate tax value of the shares in a family-owned business, the court rejected the government's position that the fact that the price under the agreement was below fair market value meant that the agreement was a device to transfer the shares to the objects of the decedent's bounty.

b. The court held that "the reasonableness of the price set forth in a restrictive agreement should be evaluated based on the facts in existence at the date the agreement is reached unless intervening circumstances occur."
c. In addition, intent to use the agreement as a testamentary disposition must be present before the agreement is held invalid.

4. The owners may be tempted to set an artificially low price in the buy-sell agreement in an attempt to reduce the federal estate tax of a deceased owner, especially when the owners are related.

a. I.R.C. § 2703 should preclude related parties from depressing the value through buy-sell agreements.

b. In the case of unrelated owners who may still attempt to depress the value of an interest through a buy-sell agreement, the difference between the price of the interest under the agreement and the fair market value of the interest can be made up through the use of group term life insurance under I.R.C. § 79, split-dollar insurance arrangements, and death benefit only plans.

(1) The benefits under these plans may be arranged so that they are not included in the deceased owner's estate, generally through the use of irrevocable trusts in the case of insurance arrangements.

(2) Nevertheless, there are problems with using an artificially low price to reduce the estate tax value of the interest.

(a) The buy-sell agreement may not qualify as bona fide.

(b) Because dispositions during lifetime must be made at the lower price set out in the agreement if the agreement is to be effective for establishing the estate tax value, such a plan may not be acceptable to owners who end up having to sell their interests before death.

(c) As a result of the reduced value of the interest, the estate may fail to qualify under I.R.C. §§ 303 (providing for sale or exchange treatment for certain redemptions), 2032A (special use valuation for real property used in farming or other small business), 2057 (exclusion for qualified family-owned business interests), and 6166 (installment payments of the estate tax attributable to small business interests).
B. The Impact of Chapter 14 on Valuation.

1. I.R.C. § 2703, added by RRA 90, has a direct impact on the effectiveness of a buy-sell agreement in establishing the value of an interest in family controlled partnerships and corporations for estate tax purposes.

   a. Although it could be argued that I.R.C. § 2703 does not change existing law in a significant way, the new provision makes it clear that the fourth requirement discussed above, i.e., that the agreement must be a bona fide business arrangement and not a device to pass the interest to the natural objects of the deceased owner's bounty without full and adequate consideration, consists of two separate requirements.

   b. Consequently, merely because an agreement is a bona fide business arrangement does not mean that it will establish the value for estate tax purposes unless the agreement is not a device to pass stock or a partnership interest to the natural objects of the deceased owner's bounty without full and adequate consideration.

   c. In addition, I.R.C. § 2703 adds a third requirement: the terms of the buy-sell agreement must be comparable to similar arrangements entered into in an arm's length transaction.

2. The general rule under I.R.C. § 2703 is that, for purposes of estate, gift, and generation-skipping transfer taxes, the value of any property is determined without regard to any right or restriction relating to the property. I.R.C. § 2703(a); Treas. Reg. § 25.2703-1(a).

3. A right or restriction means:

   a. Any option, agreement, or other right to acquire or use the property at a price less than the fair market value (determined without regard to the option, agreement or right); or

   b. Any restriction on the right to sell or use such property.


   (1) A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, shareholders' agreement, or any other agreement. A right or restriction may be implicit in the capital structure of the entity. Treas. Reg. § 25.2703-1(a)(3).
4. A lease will be disregarded in valuing property for federal gift, estate and generation-skipping transfer tax purposes if the terms are not comparable to leases of similar property entered into among unrelated parties. Treas. Reg. § 25.2703-1(d), Example 1.

5. A perpetual restriction on the use of real property that qualified for a charitable deduction under either I.R.C. § 2522(d) or 2055(f) is not treated as a right or restriction. Treas. Reg. § 25.2703-1(a)(4).

C. Exceptions.

1. Statutory exception.

a. A right or restriction will not be disregarded if it satisfies 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 the property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and

(3) The terms of the right or restriction are comparable to similar arrangements entered into by persons in an arms' length transaction.


b. The regulations make two changes to the statutory language.

(1) In the regulations, the second requirement refers to "objects of the transferor's bounty" rather than "members of the decedent's family." I.R.C. § 2703(b)(2).

(a) Thus the regulations make it clear that I.R.C. § 2703 applies for gift tax purposes as well as estate tax purposes and expands the definition of members of the transferor's family to objects of the transferor's bounty.

(b) The Technical Corrections Bill, § 102(f)(12), would have codified the change in the second requirement from members of the decedent's family to the
natural objects of the transferor's bounty; however, the change was not part of the technical corrections provision in the Small Business Act.

(2) The regulations add "at the time the right or restriction is created" to the third requirement, making it clear that the terms of the agreement are compared with similar agreements at the time the agreement is entered into, not when any rights conferred by the agreement are exercised, such as at the death of the transferor.

c. Each of the three requirements must be independently satisfied for a right or restriction to meet the exception.

(1) The mere showing that a right or restriction is a bona fide business arrangement is not sufficient to establish the absence of a device to transfer property for less than full and adequate consideration.


d. A right or restriction is treated as comparable to similar arrangements entered into by persons in an arms' length transaction if the right or restriction would have been obtained in a fair bargain among unrelated parties in the same business dealing at arms' length.

(1) A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business.

(2) This determination will generally entail a consideration of such factors as:

(a) The expected term of the agreement;
(b) The current fair market value of the property;
(c) Anticipated changes in value during the term of the agreement; and
(d) The adequacy of any consideration given in exchange for the rights granted.


(3) Evidence of general business practice.

(a) Evidence of general business practice is not met by showing isolated comparables.
(b) If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods.
(c) It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement.
(d) If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.


2. Regulatory exception.

a. A right or restriction is considered to meet each of the three requirements if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family.

(1) Consequently, in such a case the agreement would have to satisfy only the first three requirements under the case and regulatory law before the adoption of Chapter 14; i.e., fixed or formula price, restriction applicable during life, and estate obligated to sell at death.
b. In order to meet this exception, the property owned by the unrelated parties must be subject to the right or restriction to the same extent as property owned by the transferor.

c. Members of the transferor's family are the transferor, applicable family members (the transferor's spouse, ancestors of the transferor and transferor's spouse, and spouses of such ancestors) and any lineal descendants of the parents of the transferor or the transferor's spouse, and natural objects of the transferor's bounty.

(1) Any property held by a member of the transferor's family under the indirect ownership rules applicable to I.R.C. § 2701 are treated as held only by a member of the transferor's family.


3. If property is subject to more than one right or restriction, the failure of a right or restriction to satisfy the three requirements described above does not cause any other right or restriction to fail to satisfy those requirements if the right or restriction otherwise meets those requirements.

a. Whether separate provisions are separate rights or restrictions, or are integral parts of a single right or restriction, depends on all the facts and circumstances.

Treas. Reg. § 25.2703-1(b)(5).

4. According to the Senate Finance Committee Report at p. 68, I.R.C. § 2703 does not otherwise alter the requirements for giving weight to a buy-sell agreement.

a. For example, it leaves intact present law rules requiring that an agreement have lifetime restrictions in order to establish the value of the business at death, that the price be fixed or determinable, and that the estate be obligated to sell at the price determined under the agreement.

D. Modifications of Buy-Sell Agreements.

1. A right or restriction that is substantially modified is treated as a right or restriction created on the date of modification.
a. Section 2703 applies to a buy-sell agreement entered into before October 9, 1990 if it is substantially modified after October 8, 1990.

b. Note that if a buy-sell agreement intended to satisfy the statutory exception is substantially modified, the terms of the agreement must be reviewed to determine whether they are comparable to similar arrangements entered into by persons in an arm's length transaction as of the date of the substantial modification.

2. The regulations provide some guidance as to what will be considered a substantial modification.

a. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a de minimis change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification.

b. If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless it can be shown that updating would not have resulted in a substantial modification.

c. The addition of any family member as a party to a right or restriction (including by reason of a transfer of property that subjects the transferee family member to a right or restriction with respect to the transferred property) is considered a substantial modification unless:

(1) The addition is mandatory under the terms of the right or restriction; or

(2) The added family member is assigned to a generation (determined under the generation-skipping transfer tax rules (I.R.C. § 2651)) no lower than the lowest generation occupied by individuals already party to the right or restriction.

Treas. Reg. § 25.2703-1(c)(1); Treas. Reg. § 25.2703-1(d), Example 2.
3. The following are not considered substantial modifications:
   a. A modification required by the terms of a right or restriction;
   b. A discretionary modification of the agreement conferring a right or restriction if the modification does not change the right or restriction (for example an amendment to change the company's name or registered agent, Treas. Reg. § 25.2703-1(d), Example 3);
   c. A modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate; and
   d. A modification that results in an option price that more closely approximates fair market value.

Treas. Reg. § 25.2703-1(c)(2).

E. Effective Dates.

1. Section 2703 applies to any right or restriction created or substantially modified after October 8, 1990. Act § 11602(e)(1)(A) (ii)(II); Treas. Reg. § 25.2703-2.

2. The final regulations were effective on January 28, 1992.

3. For transactions occurring before January 28, 1992, and for purposes of determining whether an event occurring before January 28, 1992 constitutes a substantial modification, taxpayers may rely on any reasonable interpretation of the statutory provisions. The proposed regulations and the final regulations are considered reasonable interpretations of the statute. Treas. Reg. § 25.2703-2.

F. Planning.

1. Nonfamily-controlled corporations.
   a. If more than 50 percent of a business is owned by nonfamily members or persons who are not objects of the transferor's bounty, the traditional rules applicable to establishing the estate tax value of the business through the use of a buy-sell agreement should apply.
In such a case, there will be no requirement that the agreement be a bona fide business arrangement and not a testamentary device.

The regulations should expand this exception to apply when the same family owns no more than 50 percent of the interests or when two or more unrelated persons each own more than a de minimus interest in the business. In the real world, two or more unrelated parties are not likely to agree to a lower price for the business interest just to reduce estate taxes, since the amount passing to his or her beneficiaries would be reduced.

A buy-sell agreement among unrelated parties, or in cases where no family controls the entity, may not be required to satisfy any of the historical requirements in order for the value of the interest to be determined by the price established under the agreement.

If the parties were dealing at arm's length at the time the agreement was executed, a court should be reluctant to require the estate of a deceased owner to report for estate tax purposes a value for the interest in excess of the proceeds the estate receives in a sale pursuant to the buy-sell agreement.

However, in a case dealing with a nonfamily controlled corporation, the court, in holding that the purchase price established under a buy-sell agreement was the proper value for estate tax purposes, did refer to the traditional test.

The court stated:

As we pointed out in Estate of Bischoff v. Commissioner [Dec. 34,702], 69 T.C. 32, 39 (1977), it has long been recognized that a buy-sell agreement in effect at the date of a decedent's death may fix the value of the stock of a closely held corporation if: (1) It is an enforceable agreement, (2) it applied to the stock during the lifetime of the decedent as well as at his death, and (3) it had a bona fide business purpose rather than being testamentary in nature. The fact that there is a family relationship between the individuals to an agreement does not cause such agreements always
to be ignored, but the lack of such relationship has been considered evidence of a lack of testamentary intent by the agreement.

(b) The court found that because there was a business purpose for the agreement and the price was at least an arm's length negotiated price, the agreement was reasonable at the time it was entered into.

(c) Note that in this case the purchase price under the agreement for the decedent's stock (50 percent of the total outstanding shares) was $107,073, whereas one-half of the value of the assets received by the remaining shareholder upon the liquidation of the corporation two months later was $538,615.


2. Family-controlled businesses.

a. Modifications of buy-sell agreements entered into before October 9, 1990 should be carefully scrutinized to avoid losing the grandfather protection; if the existing buy-sell agreement satisfies the requirements applicable to such agreements before the effective date of I.R.C. § 2703, the price determined under the agreement will establish the value of the interest for estate tax purposes.

(1) If a family member becomes an owner after October 8, 1990, and adding him or her as a party to the agreement would be considered a material modification, a separate agreement with the new owner may avoid losing the grandfather protection.

(2) It may also be advisable when entering into a buy-sell agreement to include all family members currently alive as parties to the agreement and to require in the agreement that any after-born members of the family must become not only parties to the agreement but also equity owners of the business.

b. If a buy-sell agreement will have to satisfy the three requirements under the statutory exception to I.R.C. § 2703 in order to establish the value for estate tax purposes, the most difficult requirement to satisfy in many cases will be the third requirement.
(1) The third requirement states that, at the time the right or restriction is created, the terms of the right or restriction must be comparable to similar arrangements entered into by persons in an arm's length transaction.

(2) This may require assembling evidence at the time the buy-sell agreement is entered into.

(3) In comparing the Hall case (Hall Estate v. Commissioner, 92 T.C. 312 (1989)) and the Carpenter case with the St. Louis County Bank v. U.S., 674 F.2d 1207 (8th Cir. 1982), and Estate of Lauder v. Commissioner, 60 T.C.M. 977 (1990), it is obvious that a formula price under a buy-sell agreement will not be effective for establishing the value for estate tax purposes if:

(a) There is no evidence that an attempt was made to arrive at a formula price based on objective standards at the time the parties entered into the agreement;

(b) The nature of the business changed considerably since the original formula was established; or

(c) The agreement was not enforced with respect to transfers occurring before the decedent's death.

c. In the case of a buy-sell agreement among parties that may be disregarded for establishing the value of the business interest for estate tax purposes, careful attention should be given to the source of the payment of any estate tax on the value in excess of the purchase price under the agreement.

(1) Also, the effect on the marital deduction should be considered since the value for marital deduction purposes may be reduced because of the buy-sell agreement, even though the value for estate tax purposes disregards the buy-sell agreement.

(2) In Technical Advice Memorandum (TAM) 9139001, a trust designed to qualify for the marital deduction as a QTIP trust was funded with shares subject to an option held by the son to purchase the shares at book value. The IRS held that since the son had a power to appoint the assets to
someone other than the spouse (namely, himself) for less than full and adequate consideration, the QTIP requirements were not satisfied. See also TAM 9147065.

d. Note that an appraiser may value an interest in a closely-held business not having a buy-sell agreement at a lower value than if it had such an agreement because of the lack of marketability of the interest and the uncertainty as to the future of the business caused by the lack of such an agreement.