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All in the Family (Partnership)

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ALL IN THE FAMILY
(PARTNERSHIP)

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I. Why a Family Partnership?

A. Continuity of Management. If the taxpayer and/or members of the taxpayer’s family own a large parcel of real estate, proper management of the real estate investment becomes increasingly difficult as ownership becomes diffused among multiple family members. Ownership of undivided interests requires everyone to act in tandem in order to (for example) sell, mortgage or lease the property. Management problems will be compounded geometrically if the property is retained into further generations and ownership is spread among an even greater number of individuals. If the property is placed in a family limited partnership with management by selected general partners, ownership can be safely spread among family members through transfers of limited partnership interests while at the same time maintaining centralized management in one or more general partners.

Family partnerships are also useful to consolidate the management of other family assets. For example, various trusts and other family entities may have been created over the years which hold assets (real or personal property) that could be more effectively managed by consolidating them into one entity. These entities may join together (perhaps with one or more family members) and form a new family partnership for this purpose.

B. Asset Protection. The creation of a family partnership may also provide at least limited protection of each family member’s interest in the event of divorce, attachment by creditors, bankruptcy and similar involuntary transfers. This protection is available because any creditor who attempts to seize a partner’s interest in the partnership will normally be entitled to a "charging order" under the partnership statutes of most states. The "charging order" provides the creditor with a right to receive distributions of cash from the partnership as and when they are made, but will not entitle the creditor to be substituted as a full partner in the partnership unless approved by the
remaining partners. See, §18(g) of the Uniform Partnership Act ("UPA"), and §301(b) of the Revised Uniform Limited Partnership Act ("RULPA"). Thus, the judgment creditor will not ordinarily have a voice in management, cannot force a partition of properties within the partnership and, for the most part, cannot interfere with the ongoing management of the partnership properties.

1. Will Judgment Creditor (or Its Assignee) Be Treated as a Partner for Tax Purposes? If the judgment creditor or its assignee is treated as the "owner" of the partnership interest for federal income tax purposes, it will be taxed on its full allocable share of partnership income, whether or not distributed. See, Rev.Rul. 77-137, 1977-1 C.B. 178; cf. Jackson v. Commissioner, 42 T.C.M. 1413 (1981). If taxable income exceeds cash distributions, the partnership interest may become more of a liability than an asset to the judgment creditor. However, the debtor-partner may be taxed on the income attributable to the seized interest under the theory that this is economically identical to a garnishment and that the income is satisfying the obligations of the debtor-partner.

2. Fraudulent Transfers. If property is transferred to a family partnership to avoid existing or pending claims, the transfer into the partnership (or the transfer of a partnership interest) may be set aside by a court.

C. Tax Advantages.

1. Income Shifting. Historically, the opportunity to shift income from high bracket taxpayers to their lower bracket children was the primary impetus for most family partnerships. However, changes wrought by the Tax Reform Act of 1986 ("TRA '86") have substantially diminished this advantage.

   a. Compression of tax rates (although later Acts have at least partially decompressed rates again).

   b. Unearned income of children under age 14 now taxed at parents' top marginal tax rates. See, §1(g).
c. Application of top 39.6% marginal rates to income of trusts in excess of $7,500. See, §1(e).

2. Other Income Tax Advantages. A partnership is a "pass-through entity" for federal income tax purposes which is not subject to an entity-level tax.

a. Items of income, deduction and credit may be specially allocated (i.e., other than in proportion to capital) among the partners provided that such allocations meet the "substantial economic effect" rules of §704(b) and the regulations thereunder, and provided that any such allocations do not violate any of the prohibitions of §704(e)(2) discussed infra at II.H.

b. Upon the death of a family partner, the deceased partner's estate or other successor-in-interest will take a new (hopefully, "stepped-up") basis in the decedent's partnership interest under §1014. If the partnership timely files an election under §754, or has previously filed such an election, the estate or other successor will also be entitled to step-up its basis in its proportionate share of the partnership's assets under §743(b).

c. The partnership can ordinarily be liquidated and dissolved without tax cost to the partners.

3. Estate and Gift Tax Savings. The family partnership will often serve as a compliment to the traditional estate plan which generally is structured to fully utilize available unified credits, the unlimited marital deduction, lifetime giving which fully utilizes all available annual exclusions, and structuring ownership of life insurance to minimize or avoid estate and gift taxes. Interests in family partnerships may be ideal subjects of lifetime or testamentary transfers to facilitate these traditional objectives with the following additional transfer tax minimization advantages:
a. Valuation discounts. Factionalization of ownership through the creation of a family limited partnership and the use of lifetime transfers of limited partner interests therein will, if properly structured, significantly minimize the transfer tax cost of these gifts due to the minority and marketability discounts. See, discussion in III.B.1, 2 and 3, infra.

b. Shift future appreciation out of taxpayer's estate either through transfer of a "vertical slice" of the partnership (i.e., straight percentage capital interest), or through freeze technique (see, discussion in III.C., infra).

c. Fractionalization of partnership interests (e.g., GRATs, split purchases, etc.).

D. Choice of Entity.

1. Limited Partnership. The ideal form of entity to accomplish the objectives described in A, B and C above. Enjoys all of the tax benefits and allows older generation to control the affairs of the partnership as general partners. Also limits ability of younger limited partners to withdraw from the partnership.

2. General Partnership. Same tax advantages as a limited partnership, but doesn't afford older generation the same degree of control over management of the partnership. In addition, all partners have joint or joint and several liability and all partners have the right to withdraw.

3. S Corporation. Although offering limited liability to all family shareholders, the numerous restrictions applicable to S corporations usually make it a less desirable form of entity to preserve and manage family assets.

   a. Restrictions on ownership of stock -- limited to 35 shareholders and only individuals, estates and certain types of trusts.
Changes made in the Small Business Job Protection Act of 1996 ("SBT"), P.L.104-188, have liberalized the stock ownership rules to some degree. For example, the maximum number of shareholders has been increased to 75; a new category of trust, the "electing small business trust," has been added to the list of permissible shareholders; and S corporations may be members of an affiliated group. Most changes are effective for taxable years beginning after 12/31/96.

b. Allocations of income and loss must always be in proportion to stock.

c. No opportunity to step-up basis of S corporation's assets at death (i.e., no counterpart to §754 election in Subchapter S).

d. Penalty tax at corporate level on investment income and on built-in gains if S corporation was a former C corporation.

e. Liquidation of S corporation will ordinarily have tax cost to shareholders.

4. Trusts. Do not enjoy flexibility of partnerships, and are subject to high entity level taxes on accumulated income. Must also use special Crummey powers to obtain benefits of annual exclusions for gifts in trust.

5. Limited Liability Companies. Would not generally be used in Florida for preservation and management of family assets due to imposition of Florida corporate income tax. In addition, members' rights of withdrawal undermine continuity of control that most clients seek. If withdrawal rights are restricted, §2704(b) (discussed at part III.B.4., infra) may pose a problem to obtaining discounts for valuation purposes.

II. Evolution of Income Tax Treatment of Family Partnerships.

A. Early Cases. Early cases addressing the validity of family partnerships were generally liberal in
upholding their partnership status for federal income tax purposes so long as the economic arrangement would be recognized as a partnership under local law. See, e.g., Commissioner v. Olds, 60 F.2d 252 (6th Cir. 1932); Crane v. Commissioner, 19 B.T.A. 577 (1930).

B. Impact of Assignment of Income Cases. Family partnerships were originally formed as a means to shift income from a high bracket family member to lower bracket family members. In the 1930s and 40s the assignment of income principles were developed as a result of several landmark Supreme Court decisions [Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Horst, 311 U.S. 112 (1940); and Blair v. Commissioner, 300 U.S. 5 (1937)], and family partnerships were then re-examined under an entirely different light because they were obviously designed to shift income to lower bracket family members.

1. Commissioner v. Tower. In Commissioner v. Tower, 327 U.S. 280 (1946), the taxpayer transferred stock in a closely held corporation to his wife. The Corporation was then liquidated and its assets were conveyed to a limited partnership in which the taxpayer and an unrelated party were the sole general partners and the taxpayer’s wife was the sole limited partner. The taxpayer’s wife was not involved in the conduct of the partnership’s business and contributed no capital other than the assets she had received in liquidation of the corporation. The Supreme Court stated that the mere fact that a partner is recognized as such under state law is not determinative of such partner’s status for federal income tax purposes. The Court stated that this determination can only be made by determining whether the parties (particularly the family members) really intended to join together and conduct a business through a partnership. The Court acknowledged that the taxpayer’s wife could be recognized as a partner in the partnership with her husband on the following basis:

"If she either invests capital originating with her, or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these
things . . ." 327 U.S. at 290 (emphasis supplied)

The Court then examined the facts before it in light of this newly articulated standard and concluded that the wife was a partner in form only and should not be recognized as such for tax purposes because she brought nothing of her own (i.e., that was not given to her by her husband) to the partnership. Thus, the Court determined that the partnership represented an improper attempt to assign income from the taxpayer-husband to his wife.

a. Based upon the Supreme Court's decision in *Tower* and its similar companion case, *Lusthaus v. Commissioner*, 327 U.S. 293 (1946), lower courts concluded that recognition of a family member as a partner required a contribution of either "original capital" or "vital services" (or both). See, e.g., *Greenberg v. Commissioner*, 158 F.2d 800 (6th Cir. 1946); *Dawson v. Commissioner*, 163 F.2d 664 (6th Cir. 1947); *Lang v. Commissioner*, 7 T.C. 6 (1946); and *Simons v. Commissioner*, 7 T.C. 114 (1946).

b. The application of this test in the family partnership area was inconsistent with the broader assignment of income principles established by the Court in *Horst* and *Blair* which held that the income attributable to property is taxable to the owner of the property, regardless of how the taxpayer-owner obtained ownership of the property.

2. *Culbertson v. United States*. The landmark case in the family partnership area is *Culbertson v. United States*, 337 U.S. 733 (1949). The Supreme Court, perhaps recognizing the confusion that its decision in *Tower* had engendered, disavowed the "original capital or vital services" requirement, at least to the extent that it had been elevated to the status of an absolute standard. Instead, the Court stated that a determination of whether a family member is to be recognized as a partner for federal income tax purposes must be based upon examination of all relevant facts and circumstances:
"... the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent -- the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." 337 U.S. at 742, 743.

Most importantly, the Court next examined the family partnership issue in light of the assignment of income principles it had previously established. The Court acknowledged that in some instances it would be proper to treat a donee partner as the owner of a partnership interest for tax purposes, but also noted that:

"... the family relationship often makes it possible for one to shift tax incidence by surface changes of ownership ... " 337 U.S. at 746.

Thus, the Court shifted its focus to a determination of whether the transferee family member was the true owner of the partnership interest, both possessing the benefits and burdens of ownership and exercising true dominion and control over the partnership interest, or, at the other end of the spectrum, whether the taxpayer-donor had in reality retained dominion and control over the transferred interest.

C. Section 704(e) -- the Congressional Response.
Despite the Supreme Court's efforts to clarify the tax treatment of family partnerships in Culbertson, a great deal of uncertainty remained. In 1951, Congress enacted the predecessor of §704(e) to bring order into the family partnership arena.

1. General Rules of §704(e). Section 704(e)(1) provides that:

"A person shall be recognized as a partner ... if he owns a capital interest in a partnership in which capital is a material
income-producing factor, whether or not such interest was derived by purchase or gift from any other person."

Thus, the concepts of "original capital" and "vital services" are clearly no longer applicable, at least to the extent §704(e) applies.

a. Section 704(e) should be viewed as a safe harbor and not as an exclusive standard for recognition of family partnerships. For example, if a donee partner does not own a capital interest (e.g., if a family member holds only a profits interest), or if capital is not a material income-producing factor, presumably the taxpayer can still fall back on the tests established in Culbertson to establish his status as a true partner for federal income tax purposes. See, e.g., Nichols v. Commissioner, 32 T.C. 1322 (1959), acq., 1960-2 C.B. 6, in which the wife of a medical doctor was recognized as a partner in a partnership with her husband even though it was acknowledged that his services generated all of the gross revenues of the medical practice conducted by the partnership and even though she was not recognized as a partner under state law (because she was not a doctor). The determinative factor was the Court's finding that she performed valuable management services on behalf of the partnership and that she did so in her capacity as a partner.

2. Capital as a Material Income-Producing Factor. Capital will be a "material income-producing factor" if "... a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership." Reg. §1.704-1(e)(1)(iv). This definition is designed to exclude service partnerships in which fees, commissions or other compensation for personal services is a principal source of income.

3. "Ownership" of a Capital Interest. Even if capital is a material income-producing factor, the donee partner must be the "real owner" of the partnership interest. Reg. §1.704-
1(e)(1)(iii). This portion of the Regulations goes on to provide as follows:

"To be recognized, a transfer must vest dominion and control of the partnership interest in the transferee. The existence of such dominion and control in the donee is to be determined from all the facts and circumstances. A transfer is not recognized if the transferor retains such incidents of ownership that the transferee has not acquired full and complete ownership of the partnership interest."

The basic criteria for determining real ownership, as outlined in Reg. §1.704-1(e)(2), are as follows:

a. Execution of legally sufficient and irrevocable deeds and other transfer documents is an important factor, but this will not, in and of itself, establish real ownership. Reg. §1.704-1(e)(2); Leo A. Woodbury, 49 T.C. 180 (1967); and see, Spiesman v. Commissioner, 260 F.2d 940 (9th Cir. 1958).

b. The controls retained, directly or indirectly, by the donor may not be so substantial as to deprive the donee of significant benefits of ownership. Reg. §1.704-1(e)(2)(ii). However, the legislative history of §704(e) recognizes certain controls and restrictions imposed in accordance with the normal business practices should not be regarded as an improper retention of controls.

"... not every restriction upon the complete and unfettered control by the donee of the property donated will be indicative of sham in the transaction. Contractual restrictions may be of the character incident to the normal relationships among partners. Substantial powers may be retained by the transferor as a managing partner or in any other fiduciary capacity which, when considered in the light of all the circumstances, will not indicate any lack of true ownership in the

c. Retention of control of the distribution of income or restrictions on distribution of amounts of income by the donor may indicate that the donor has not parted with control. The Regulation recognizes that income must be retained to meet the reasonable needs of the business. This will not be a negative factor if the donee partner has a voice in determining whether and to what extent income must be retained or, if there is a managing partner who is to make such decisions, such participation by the donee partner will not be necessary so long as income is not accumulated beyond the reasonable needs of the business.

(1) An accumulation of the donee-partner's income at the partnership level coupled with distributions of the donor-partner's allocable share of income would undoubtedly be viewed by the Service as indicative of an improper retention of controls.

(2) In drafting partnership agreements for family partnerships, it may be advisable to include a prohibition against accumulations of income beyond the reasonable needs of the business. Of course, the mere inclusion of such a provision will not suffice if it is not followed in practice.

d. Reg. §1.704-1(e)(2)(ii)(b) provides that limitations placed upon the right of the donee to liquidate or sell his interest in the partnership without financial detriment will be treated as a significant retention of controls by the donor-
partner. This poses a difficult problem to the draftsman. On the one hand, it is prudent planning to place some limitations on the transferability of a partner's interest since the partnership is a very close, personal form of organization (especially if it is a general partnership) and the partners may be either jointly or jointly and severally liable for the debts created by other partners in the partnership. In short, it is generally prudent business practice to place some restrictions on the transferability of partnership interests. On the other hand, an absolute prohibition against the assignment of a partnership interest would clearly run afoul of the Regulations. For drafting purposes, it would probably be advisable to provide a right of first refusal in the event that the donee-partner wishes to sell his interest to an outsider. These restrictions are fairly commonplace and, in any event, should be applicable to all partners in the partnership (i.e., not just to the donee-partner).

e. Retention of control of assets essential to the business may be another adverse indication of retention of control. Reg. §1.704-1(e)(2)(ii)(c). The Regulations cite as an example the retention by the donor of ownership of key assets necessary for the conduct of the partnership's business coupled with the leasing of such assets to the partnership. However, one leading commentator notes that the retention and leasing of the major asset by the donor should not warrant ignoring the donee-partner as a partner in the partnership if the lease is on commercially reasonable terms and does not provide the donor-partner with abnormal power to control the partnership's business (and provided that the partnership also has other capital which is a material income-producing factor). McKee, Nelson & Wittmire, Federal Taxation of Partnerships and Partners, 2d Ed., ¶14.03[2][c].
f. Another factor cited in Reg. §1.704-1(e)(2)(ii) is the retention of management powers inconsistent with normal relationships among partners. However, this provision goes on to provide that retention by the donor of control of business management or of voting control such as is common in ordinary business relationships will not by itself be considered inconsistent with true ownership by the donee-partner if the donee is free to liquidate his interest at his discretion without financial detriment. This freedom will only be present, according to the Regulation, if "... it is evident that the donee is independent of the donor and has such maturity and understanding of his rights as to be capable of deciding to exercise, and is capable of exercising, his right to withdraw his capital interest from the partnership."

g. If a donee-partner participates to a substantial degree in the control and management of the business (including participation in major policy decisions), this will be "strong evidence" of the donee-partner's exercise of dominion and control over his interest. Reg. §1.704-1(e)(2)(iv).

h. The actual distribution of the entire amount or a major portion of a donee-partner's distributive share of business income for his benefit and use will also be treated as substantial evidence of the reality of the donee's interest. Reg. §1.704-1(e)(2)(v). However, if these amounts are then deposited, loaned or invested in such a manner that the donor controls or can control the use or enjoyment of such funds, the physical distribution of the income will be ignored. Id.

i. The last test of determining the reality of the donee's ownership of a partnership interest is whether or not the donee is actually treated as a partner in the operation of the business. In short, the donee should be held out to the public as
j. a partner in the partnership, including compliance with local partnership laws, fictitious name registration requirements and business registration statutes. Reg. §1.704-1(e)(2)(vi).

D. Trustees as Partners. A partnership interest in a family partnership may be transferred in trust rather than directly to a family member, and the trustee will be recognized as a partner for federal income tax purposes, if the trustee is recognized as the "true owner" of the partnership interest under the rules set forth in C.3., supra. Reg. §1.704-1(e)(2)(vii).

1. The regulations indicate that if the trustee is "independent of the grantor," and participates as a partner and receives a distribution of income, the trustee will ordinarily be recognized as a legal owner of the partnership interest unless the grantor has retained controls (discussed in C.3., supra) inconsistent with such ownership. The Regulation goes on to provide that "However, if the grantor is the trustee, or if the trustee is amenable to the will of the grantor, the provisions of the trust instrument (particularly as to whether the trustee is subject to the responsibilities of a fiduciary), the provisions of the partnership agreement and the conduct of the parties must all be taken into account in determining whether the trustee in a fiduciary capacity has become the real owner of the partnership interest." In such a case, the grantor or the non-independent trustee must actually represent and protect the interest of the beneficiaries as a fiduciary in order to establish that the trust is the true owner of the partnership interest.

a. The courts closely scrutinize any family partnership in which some or all of the partners are family trusts in which the grantor or a close relative serves as trustee. See, e.g., Bateman v. United States, 490 F.2d 549 (9th Cir. 1973); Kuney v. United States, 524 F.2d 795 (9th Cir. 1975); and Paul Buehner, 65 T.C. 723 (1976). For best results, an independent trustee should be utilized wherever possible but, if not possible, both the
trust document and the partnership agreement should be carefully drafted to preclude actions by the trustee which are inconsistent with the best interests of the trust.

b. Perhaps more importantly, the actual operation of the partnership must be conducted in such a way that the trustee-partners are at all times treated fairly and are allowed to, and do, participate as partners.

2. Care must also be taken to insure that the grantor will not be treated as the owner of a portion of the income otherwise attributable to the donee family members under the grantor trust rules of §§671 through 678. The trust instrument should be carefully drafted to specifically preclude the grantor from exercising any powers which would be deemed to enable him to control beneficial enjoyment of income (§674) and to eliminate certain administrative powers referred to in §675. For a discussion of the interrelationship with the grantor trust rules with the family partnership rules, see, "Family Partnerships," 346-2nd BNA Tax Mgmt. Portfolios at pp.A-12 and A-13.

3. If a limited partnership interest is transferred to an irrevocable trust that is authorized to accumulate income and is taxed under §661, partnership income may be unexpectedly trapped in the trust at times when it does not have sufficient cash to pay its tax liability.

a. Example. Trust A, an irrevocable trust which is taxed under §661, holds a 25% interest as a limited partner in the profits, losses and cash flow of Partnership X. In year one, Partnership X has $100,000 of taxable income and distributes $40,000 of cash proportionately to its partners. Trust A's distributable share of income of Partnership X is $25,000, which constitutes all of the income of Trust A in year one. Trust A also receives a cash distribution of $10,000 from the partnership. A distribution in the amount of $5,000 is made by Trust A to its sole
income beneficiary in accordance with the discretionary income distribution provisions of the governing trust instrument. Trust A's taxable income for year one is $20,000 ($25,000 distributable share of partnership income less $5,000 deduction under §661(a)(2)), and its federal income tax liability for year one is $7,000. However, because it distributed $5,000 of its cash for year one, the trust has only $5,000 remaining cash available to pay its taxes.

E. Minor Children as Partners. If an interest in a family partnership is transferred directly to a donee who is still a minor under state law, the Regulations provide that the minor will not be recognized as a partner unless he "... is shown to be competent to manage his own property and participate in the partnership activities in accordance with his interest in the property ..." Reg. §1.704-1(e)(2)(viii). However, this Regulation contains an exception if control of the partnership interest is exercised by a person in a fiduciary capacity for the sole benefit of the child and such control is exercised under such judicial supervision as is required by state law. If a taxpayer desires to transfer a partnership interest to a minor, it is almost always advisable to do so in trust or at least through a transfer under the Uniform Gifts to Minors Act or the Uniform Transfers to Minors Act.

F. Limited Partnership Interests. Reg. §1.704-1(e)(2)(ix) states that a donee's interest as a limited partner in a limited partnership will be recognized if the donee has acquired dominion and control over the interest. Under the Revised Uniform Limited Partnership Act, as enacted in most states, a limited partner is generally prohibited from participating in the management of the partnership which, on its face, would violate one or more of the "reality of ownership" rules discussed above. However, in recognition of the special nature of a limited partnership, the Regulations provide that the mere absence of the rendering of services or participation in the management by a donee limited partner will not be construed to indicate that he is not the real owner of the partnership interest if his interest is not subject to substantial restrictions prohibiting transfer or liquidation and if the general partner does not retain controls which would substantially limit any
of the rights which would ordinarily be exercised by unrelated limited partners in normal business relationships. The Regulations also make it clear that a limited partnership must be recognized as a true partnership for federal income tax purposes.

G. Purchase of Interest in Family Partnership by Family Member. The rules discussed above with respect to "ownership" of a partnership interest are applicable to partnership interests acquired by gift. See, Reg. §1.704-1(e)(2). Thus, they generally are not applicable to a partnership interest acquired by purchase. However, Reg. §1.704-1(e)(4)(iv) provides that a purported sale will not be recognized as such unless it passes muster under the tests set forth in Reg. §1.704-1(e)(4)(ii).

1. Reg. §1.704-1(e)(4)(ii) requires that a capital interest acquired either "directly" (i.e., with cash) or by means of a loan or credit extended by a family member, will be recognized as bona fide only if one of the two following standards are met:

   a. The purchase must be arms length, as determined considering all relevant factors including the terms of the purchase agreement (e.g., reasonableness of purchase price, due date of payment, rate of interest and collateral security) as well as the terms of any loan arrangement related to the purchase; the credit standing of the purchaser and the capacity of the purchaser to incur a legally binding obligation; or

   b. It can be shown, in the absence of an arms length transaction, that the purchase was genuinely intended to promote the success of the partnership's business by securing participation by the purchaser in the business or by adding his credit to that of the partnership and the other partners.

2. Until the full purchase price is paid, satisfaction of one of the two alternate tests described above will only be taken into account "as an aid in determining whether a bona fide purchase or loan obligation existed." Reg. §1.704-1(e)(4)(ii).
3. If the transaction fails to meet the standards for recognition as a sale, the purported purchaser will be treated as having received a partnership interest by gift — i.e., he must meet the "true ownership" standards of Reg. §1.704-1(e)(2) discussed in C.3, 4, 5, and 6 above.

4. If a purported sale fails to meet the bona fide sales standards described above, or if payment of any part of the purchase price is dependent upon partnership earnings, "... the transaction may be regarded in the same light as purported gifts subject to deferred enjoyment of income. Such a transaction may be lacking in reality either as a gift or as a bona fide purchase." Reg. §1.704-1(e)(4)(i).

H. Special Rules Governing Allocations of Income and Loss Within a Family Partnership.

1. General Rules of Section 704(e)(2). Section 704(e)(2) provides that, in the case of any partnership interest created by gift, the distributive share of the donee partner will be includible in his gross income, except to the extent (i) that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and (ii) except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital.

a. Although it is not entirely clear from the language in the statute, the reference to "distributive share" presumably refers back to §702 with the result that the limitation will apply not only to income of the partnership, but also to items of deduction, loss, credit, etc. Thus, an allocation of gross income in proportion to capital coupled with a special allocation to the donor of one or more specific deductions (i.e., which would effectively reduce the donor's share of net income) that would otherwise meet the "substantial economic effect" rules of §704(b) and the regulations thereunder,
would presumably not meet the test of §704(e)(2).

b. The limitations of §704(e)(2) only apply with respect to a partnership interest that is "created by gift." However, §704(e)(3) also provides that an interest purchased by one member of a family from another will be considered as created by gift and the fair market value of the purchased interest will be considered to be donated capital. The Regulations, which also provide that a gift may be made both directly or indirectly, include three separate examples of how indirect gifts can still invoke the limitations of §704(e)(2). Reg. §1.704-1(e)(3)(ii)(a).

c. The "family" of an individual will include only his spouse, ancestors and lineal descendants and any trusts for the primary benefit of such persons. §704(e)(3).

d. The standard for "reasonable compensation" is presumably the same as set forth in §162(a)(1) (albeit with a different emphasis). Thus, the primary test will be how much would be paid to an unrelated party for rendering the same services as those rendered by the donor on behalf of the partnership. Reg. §1.704-1(e)(3)(c); see, Leo A. Woodbury, 49 T.C. 180 (1967). From a drafting standpoint, every family partnership agreement should have a special section dealing with the payment of "reasonable compensation" to donor partners for the managerial and other services rendered by them on behalf of the partnership.

III. Planning to Use Family Partnerships to Minimize Federal Estate, Gift and Generation Skipping Taxes.

A. Estate Tax Considerations.

1. Inclusion in Gross Estate. If a partner in a family partnership dies, the decedent's partnership interest must generally be included in his gross estate for federal estate tax purposes under §2033. Unlike §704(e), which looks beyond mere ownership under state law to determine if a donee is the "real owner" of the
partnership interest, §2033 dictates inclusion ". . . of all property to the extent of the 
interest therein of the decedent at the time of 
his death." Under Reg. §20.2033-1, mere legal 
ownership will generally require inclusion of 
the asset in the gross estate.

a. The partnership interest will be valued in 
accordance with general principles 
governing the valuation of other business 
Rul. 59-60, 1959-1 C.B. 237 sets forth the 
general criteria for valuing stock of a 
closely held corporation, and these same 
principles are to be applied to interests in 
C.B. 327. Valuation should take into 
account all of the unique features of the 
partnership interest including, for 
example, special allocations, whether the 
partnership interest is that of a general 
or limited partner, whether the interest 
is a controlling interest or a minority 
interest and the availability of a §754 
election. Valuation should generally be 
based upon the projected income (cash 
flow) that can reasonably be expected to 
be generated from the transferred 
partnership interest, but if the interest 
is that of a general partner or if the 
owner of the interest has the right of 
withdrawal, a liquidation method may be 
more appropriate. See, also, discussion 
re: possible impact of §2704 in part 
III.B.4., infra.

B. Use of Valuation Discounts to Minimize Transfer Tax 
Costs.

1. General. Gifts of interests in family 
partnerships, especially limited partnership 
interests, are generally discounted for lack of 
an established market for such interests 
("marketability discount") and, if applicable, 
lack of control ("minority discount"). 
Placement of an asset, such as real estate, in 
a family partnership changes the character of 
ownership from that of a direct ownership in a 
specific property to an indirect ownership in 
the form of a partnership interest. Thus, if 
non-controlling interests in the partnership 
are gifted to family members, the absence of a
market for these interests and the lack of control over the affairs of the partnership will have a material impact upon the value of the transferred interest.

2. Minority Interest. A separate and distinct discount for lack of control has generally been available in valuing minority interests in closely held businesses, based upon the inability of the interest holder to force a liquidation of the partnership, the lack of control over the management of the partnership, and other factors. Reg. §§20.2031-2(e) and (f); 25.2512-2(e) and (f); Knott v. Commissioner, 54 T.C.M. 1249 (1987); Ward v. Commissioner, 87 T.C. 78 (1986). The Service maintained for a number of years that no minority discount was warranted when an interest in a family controlled business was gifted to another family member if the donor, donee and members of their immediate family controlled the business both before and after the transfer. See, Rev. Rul. 81-253, 1981-2 C.B. 187. In essence, the Service viewed the family as a unit and, unless the transfer resulted in a loss of control to the family unit, no minority discount could be justified. However, the Service's position in this regard was consistently rejected by the courts. See, Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981); Estate of Lee v. Commissioner, 69 T.C. 860 (1978); Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982); and Minahan v. Commissioner, 88 T.C. 492 (1987). The Service finally conceded this issue in Rev. Rul. 93-12, 1993-1 C.B. 202.

a. In Rev. Rul. 93-12, a taxpayer gifted 20% of the stock of a corporation to each of his five children. Despite the fact that 100% of the stock was gifted simultaneously, the Service ruled that each gift must be valued independently of the others. Consequently, each gift of a 10% interest was entitled to a minority discount for valuation purposes. See, also, TAM 9449001.

3. Marketability Discount. The courts have also long recognized a valuation discount attributable to the lack of an established market for a partnership interest or other

4. Impact of Section 2703 on Buy-Sell Provisions and Other Restrictions. Section 2703, which was added to the Code as part of new Chapter 14 in 1990, limits the extent to which any provision of a partnership agreement which depresses the value of a transferred partnership interest may govern the value of such interest. For example, assume that a partnership agreement requires the sale and purchase of a deceased partner's interest at book value and that, upon the death of Partner A who owned a 75% interest in the profits, losses and capital of the partnership at the time of his death, the book value of such interest at death was $500 but the true fair market value (determined without regard to the buy-sell restrictions) was $1,000. Will this provision of the partnership agreement control the value of the partnership interest for federal estate tax purposes?

a. Under case law in existence prior to §2703, the value established under the buy-sell provision would only be controlling under the following conditions:

(1) The estate must be obligated to sell the interest. Anderson Estate v. Commissioner, 36 T.C.M. 972 (1977), aff'd., 619 F.2d 587 (6th Cir. 1980).

(2) The price must be fixed either in amount or pursuant to a formula which was fair at the time the agreement was entered into. Littick Estate v. Commissioner, 31 T.C. 181 (1958), acq., 1959-2 C.B. 5.

(3) The agreement must be binding during lifetime as well as at death. Anderson Estate v. Commissioner, 36 T.C.M. 972 (1977), aff'd., 619 F.2d 587 (6th Cir. 1980); Worcester County Trust Co. v. Commissioner, 134 F.2d 578 (1st Cir. 1943); and United States v. Land, 303 F.2d 170 (5th

b. Section 2703(a) provides that, for federal estate, gift and generation skipping tax purposes, the value of any property will be determined without regard to any "right or restriction relating to the property." Reg. §25.2703-1(a). A "right or restriction" means the following:

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

ii) any restriction on the right to sell or use the property.

Reg. §25.2703-1(b) (2).

(1) Exceptions. Section 2703(a) will not apply to any right or restriction that satisfies all of the following:

(a) it is a bona fide business arrangement;

(b) it is not a device to transfer property to a family member or the natural objects of the transferor's bounty for less than full and adequate consideration; and

(c) at the time the right or restriction is created, the terms of the right or restriction are comparable to similar arrangements entered into by persons in an arm's length transaction.

§2703(b); Reg. §25.2703-1(b) (1).
Reg. §25.2703-1(b) (2) emphasizes that each of these three criteria must be independently satisfied. Thus, demonstration that a restrictive
agreement is a bona fide business arrangement is not sufficient to establish that the restriction does not transfer property for less than full and adequate consideration.

(2) The first two criteria, which are set forth in §§2703(b)(1) and (2), incorporate the requirements that existed prior to the enactment of Chapter 14 discussed in a. above. See, 136 Cong.Rec. 515682 (10/18/90).

(3) The third criterion, which is found in §2703(b)(3) and requires a buy-sell provision to have terms comparable to the terms of similar arrangements entered into by persons in an arm’s length transaction, represents a significant change from prior law. Section 2703(b)(3) offers virtually no guidance on its interpretation. The Senate Finance Committee Report reflects that testimony of experts will probably be necessary to determine the comparability of similar arrangements used in other arm’s length arrangements, and states that the burden of establishing that the restriction meets this test must be borne by the taxpayer. 136 Cong.Rec. 515682 (10/18/90).

(a) Reg. §25-2703-1(b)(4) provides that a right or restriction will be considered as having met this test if it conforms with the general practice of unrelated partners under negotiated agreements in the same business. The emphasis of the regulation is clearly upon using comparable agreements entered into by unrelated parties in the same or a similar business. This will be difficult to establish since virtually all such agreements are entered into in privately negotiated transactions and are not generally available to the public.
(b) Despite the difficulty in obtaining comparables, there are a number of restrictions which are common to most partnership agreements (particularly limited partnership agreements) that hopefully will be recognized as such in applying §2703(b)(3), such as the following:

i) rights of first refusal,

ii) prohibition of withdrawal by limited partners,

iii) restrictions on pledges of partnership interests, and

iv) buyout provisions applicable to partnership interests transferred in violation of the partnership agreement or which are activated upon a default under the partnership agreement (e.g., for failure to meet a capital call).

c. IRS agents in some parts of the country have recently taken the position that the mere creation of a family partnership results in the imposition of restrictions that affect the ability of a partner to force a liquidation of the partnership as well as his ability to convey his interest in partnership properties. Under this theory, the partnership must be ignored under §2703 and any transfer of an interest in the partnership must be viewed as the transfer of an undivided interest in the partnership's properties, thus resulting in little (if any) discounts. See, Kasner, "Family Partnerships: Focus Shifts to Section 2703," Tax Notes, 610-11 (July 31, 1995).

(1) If this interpretation is correct, it would render §§2704(a) and (b), which pertain (in part) to restrictions upon liquidation imposed under a
partnership agreement, absolutely meaningless.

(2) There is nothing in §2703, the regulations issued thereunder or the legislative history of this section that suggests this result.

(3) This position is directly contrary to §7701(a)(2) and the regulations issued thereunder.

5. Impact of Section 2704 on Family Partnership Interests.

a. Estate of Harrison. The Tax Court, in Estate of Harrison v. Commissioner, 42 T.C.M. 1306 (1987), held that the value of a decedent’s interest in a family limited partnership must be valued without regard to the decedent’s right to liquidate the partnership. Mr. Harrison contributed approximately $59.5 million to a family limited partnership in exchange for a 1% general partner interest and a 77.8% limited partner interest. Each of his two sons simultaneously contributed approximately $8 million to the family limited partnership in exchange for a 10.6% general partner interest. Less than six months after the formation of the partnership, Mr. Harrison died. Shortly thereafter his two sons exercised an option to purchase the decedent’s general partner interest (but not his limited partner interest) pursuant to the terms of the limited partnership agreement. The estate reported the value of the decedent’s limited partner interest on the estate tax return at $33 million based upon a capitalization of income valuation approach. The IRS disagreed and valued the limited partner interest at $59 million using a liquidation value approach because the decedent possessed the power in his capacity as a general partner to force a liquidation of his partnership interest at net asset value. The Tax Court held in favor of Mr. Harrison’s estate on the grounds that, under both the partnership agreement and applicable state law, Mr. Harrison’s right to force a
liquidation of his partnership interest could not pass to an assignee. The net effect of the Tax Court's decision was to enable Mr. Harrison to retain liquidation control of the partnership during his lifetime while at the same time enabling his estate to value his interest in the partnership at a discounted value on the estate tax return.

b. Section 2704(a) -- Congress' response to Estate of Harrison. Section 2704(a), which was added to the Code by the Omnibus Budget Reconciliation Act of 1990 ("OBRA '90"), provides that if there is a lapse of either a voting or a liquidation right in a corporation or partnership, and the person holding such right immediately before the lapse together with members of such person's family control the entity both before and after the lapse, the lapse will be treated as a transfer of property for federal estate or gift tax purposes (depending upon whether the lapse occurred at death or during lifetime).

(1) Calculating the Amount of the Deemed Transfer. The amount of the deemed transfer is the excess of the value of the interest immediately prior to the lapse (determined as if the voting or liquidation rights were non-lapsing) over the value of such interest immediately after the lapse. §§2704(a)(2).

(a) "Control" in the case of a family partnership means 50% or more of the capital or profits interests in the partnership, or any interest held as a general partner in a family limited partnership. §§2704(c)(1) and 2701(b)(2).

(b) The "family" of a person includes such person's spouse, ancestors, lineal descendants, siblings and any spouse of the foregoing. §2704(c)(2).
(c) A "voting right" is a right to vote with respect to any matter of the partnership. Reg. §25.2704-1(a)(2)(iv).

(d) A "liquidation right" is a right to compel the partnership to acquire all or part of the owner's partnership interest, regardless of whether or not its exercise would result in the complete liquidation of the partnership. Reg. §25.2704-1(a)(2)(v). Thus, a partner would be deemed to possess a liquidation right if he has sufficient voting power to force the partnership to liquidate (redeem) all or part of his partnership interest. Significantly, Reg. §25.2704-1(c)(1) provides that a transfer of a partnership interest that has the result of a reducing the transferor partner's partnership interest below the required voting percentage level to force liquidation will not be treated as a lapse provided that rights with respect to the transferred partnership interest are not restricted or eliminated.

(2) Planning Considerations. Consider drafting the family limited partnership agreement for a stated term with no liquidation or withdrawal rights prior to expiration of the term, coupled with multiple general partners, none of whom have the unilateral right to terminate the partnership, to insure that there will be no lapse of voting or liquidation rights upon a change of general partners.

c. Section 2704(b). Section 2704(b)(1) provides in relevant part that if a taxpayer transfers an interest in a partnership to or for the benefit of a member of his family and the taxpayer together with his family members have
control of the partnership immediately prior to the transfer, then any "applicable restriction" shall be disregarded for purposes of valuing the transferred interest. For purposes of the foregoing, the same definitions of "family members" and "control" apply under §2704(b) as were applicable under §2704(a).

(1) Applicable Restrictions. An "applicable restriction" is defined in §2704(b) (2) as any restriction which limits the ability of the partnership to liquidate, and with respect to which the restriction either lapses, in whole or in part, after the transfer, or the taxpayer and each of the members of his family, either alone or collectively, have the right after the transfer to remove the restriction.

(a) Reg. §25.2704-2(a) amplifies this definition by providing that a limitation on the ability to liquidate a partnership will only be treated as an applicable restriction if the limitation is more restrictive than the limitation that would apply under applicable state law.

(2) Exceptions. Section 2704(b)(3) creates exceptions from these rules for commercially reasonable restrictions imposed in connection with a lending arrangement or equity participation by unrelated lenders or investors as well as for restrictions imposed under federal or state law.

(3) Possible Impact on Discounts. Since restrictions on the ability of the donee of a partnership interest to force a liquidation of the partnership and obtain her proportionate share of partnership assets are crucial to the availability of both minority and marketability discounts, a literal application of §2704(b) would make it
difficult to justify discounting the value of the gifted partnership interests in a controlled family partnership. However, the legislative history of §2704 indicates that the rules of §2704 are not intended to affect minority discounts or other discounts available under present law. H. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1137. Moreover, Reg. §25.2704-2(b) provides that only those liquidation restrictions that exceed the requirements of state law will be ignored under §2704(b).

(4) Planning Considerations. Some suggested procedures in drafting a family limited partnership agreement to minimize the possible impact of §2704(b) are as follows:

(a) The partnership agreement should specifically preclude the use of lapsing voting or liquidation rights if at all possible.

(b) Stay within the applicable state law provisions regarding rights of withdrawal, voting, etc.

(c) If at all possible, avoid situations in which a general partner withdraws and has her general partnership interest converted to a limited partnership interest.

(d) Consider the use of persons who are not "members of the family" as partners and require their consent in order to modify the partnership agreement, particularly with respect to voting or liquidation rights.

(e) Do not provide any partner (general or limited) with the right to unilaterally liquidate the partnership.

(f) Use multiple general partners.
6. **Evolving Position of IRS.** The IRS has become increasingly concerned about the substantial evaporation in value that is occurring through the use of family partnerships and gifts of interests therein to family members at substantial discounts.

   a. **Reg. §1.701-2**, the so-called "partnership anti-abuse regulation," was issued in final form on December 29, 1994. This regulation, which initially applied both for transfer tax as well as income tax purposes, contained two examples pertaining to family partnerships. See, Reg. §1.701-2(d), Exs. 5 and 6.

   (1) Example 5, which contained facts which the regulation deemed "non-abusive," included the following statement: "Therefore, absent other facts (such as the creation of the partnership immediately before the gifts by W) the Commissioner cannot invoke [her powers] to recast the transaction." (emphasis supplied) The implication of the parenthetical is that if H and W form a partnership with H as the general partner and W as the limited partner and W gifts all or a portion of her limited partnership interests to her children immediately after the formation of the partnership the anti-abuse regulation should be invoked to recast the transaction (presumably in a manner that would reduce or eliminate the discounts). No authority was cited for this position. Unlike §351 which contains a control requirement, §721 does not require that the transferor partners be in "control" of the partnership immediately after a transfer of property to the partnership in exchange for a partnership interest. Moreover, from a transfer tax standpoint, there appears to be no authority to allow the Commissioner to recast such a transaction as a gift of a fractionalized interest in the property followed by a contribution of the interest to a

(2) Example 6, which described a family partnership that violated the anti-abuse restrictions, was vague and confusing. Example 6 involved the transfer of a vacation home by H and W to a newly formed partnership in exchange for partnership interests. Thereafter, partnership interests were gifted to children of H and W and the value of such interests were discounted (presumably for lack of marketability and lack of control). The conclusion in Example 6 was that the partnership was not bona fide and there was no substantial business for the purported activities of the partnership. This conclusion was presumably based upon the fact that the ownership of the vacation home neither constituted a trade or business nor an investment, but rather was held solely for personal use. Further, the example implied that the sole reason for forming the partnership was to claim discounts in the gifted interests.

On January 23, 1995, the IRS issued Announcement 95-8, 1995-7 I.R.B. _____, which stated that the partnership anti-abuse regulation would be applied only for income tax purposes and would not address the transfer tax implications of partnerships. As a result, Examples 5 and 6 discussed above were deleted from the regulation. The regulations were later amended and finalized consistent with Announcement 95-8 on April 13, 1995.

Notwithstanding the issuance of Announcement 95-8, statements made by IRS and Treasury representatives at the 1995 Mid-Winter Meeting of the ABA Tax Section in Los Angeles reflected a continuing concern of the Service about the misuse of valuation discounts in family partnership settings. The clear message was that Announcement 95-8 should not be construed
as a concession of this issue by the Service. The Service apparently intends to address this issue either in future published rulings or through the issuance of regulations under other Code sections.

C. Frozen Partnerships. Estate freezes were widely employed by estate planners prior to 1987 in order to enable older family members to retain an interest in the family business but shift future appreciation and perhaps excess current income to younger family members without a transfer tax cost. This was generally accomplished through the creation of two primary classifications of equity ownership in the family business -- a preferred interest and a residual or common interest. The preferred interest would typically possess certain preferential rights to income and to liquidating distributions, and would also frequently be embellished with other features such as conversion rights and put and call rights that, for the most part, were never intended to be exercised. However, the preferred interest would not be entitled to enjoy the benefits of any returns from the family business in excess of the designated preferential return. The intent of these preferential rights was to absorb at the outset as much value into the preferential interests as possible in order to reduce the value of the residual equity interests. Most, if not all, of the residual equity interests were then gifted to younger family members. Although the preferential equity interests continued to participate in the profits of the enterprise, the ceiling imposed upon their participation effectively froze the value of preferred interests at their original level (plus any preferred distributions that were actually paid), thereby shifting all future growth (as well as current earnings in excess of the preferred return) to the residual equity interest holders with no resultant gift taxes. Although the freeze technique was most often employed in family corporations, estate freezes could also be accomplished in a partnership setting as well.

1. **Section 2036(c).** Estate freezes were virtually eliminated in 1987 by the enactment of former §2036(c). However, §2036(c) was retroactively repealed by OBRA 1990.

2. **Section 2701.** OBRA 1990 replaced §2036(c) with a more precise set of limitations on estate freezes which were incorporated in new §2701.
Section 2701 does not prohibit estate freezes, but rather provides that, for purposes of valuing the residual interests that are gifted to younger family members, all liquidation, put, call and conversion rights and preferences, together with certain distribution preferences, associated with the preferred interests will be valued at zero. In other words, §2701 prevents the preferred equity interest from soaking up most of the value of the corporation, with the obvious result that the residual interests gifted to younger family members will have a much higher value for transfer tax purposes. Distribution rights associated with the preferred equity interests will be entitled to be valued under §2701 only if they constitute rights to receive "qualified payments." In order to be classified as "qualified payments" under §2701(c)(3), the holder of the preferred equity interest must be entitled to receive a fixed amount (or an amount computed at a fixed rate) which is payable on a periodic and cumulative basis. However, an election can be made to treat non-qualified payments as constituting qualified payments. §2701(c)(3)(C). If qualified (or deemed qualified) payments are not made within an available 4-year grace period, the accumulated distributions will be treated as having been paid to the holder of the preferred equity interest on the date they were due and then reinvested by him at the applicable §7520 rate until such holder either dies or makes a lifetime gift of the preferred interest. As a result, the value of the preferred interest will be swelled by the deemed accumulation of these undistributed amounts together with the interest which is deemed to have been received with respect to such amounts.

a. Although frozen partnerships can still be created under §2701, their benefits have been diminished because the gifted residual interests will have a significantly higher value than would have been the case under prior law. However, if the family business is expected both to generate a regular and substantial cash flow and to appreciate significantly in value in the future, the partnership freeze may still have utility. See, Dees, "Now That the Monster Is Dead, Can You

D. Transfers of Fractionalized Partnership Interests.

1. Transfer of Partnership Interest to GRAT. As an alternative to a partnership freeze, a transfer of an interest in a family partnership to a Grantor Retained Annuity Trust ("GRAT"), represents another means by which anticipated future appreciation may be shifted to children at minimal gift tax cost. Under this concept, an interest in the family partnership would be transferred to an irrevocable trust in which the taxpayer, as grantor of the trust, would receive specified annuity payments (stated in terms of a percentage of the value of the partnership interest transferred to the trust at its inception) for a fixed period of years. At the expiration of the taxpayer's annuity interest, the trust would terminate and the partnership interest would be transferred either outright or in further trust to the taxpayer's children. The transfer of the future right to receive the partnership interest represents a present gift made by the taxpayer to his children. However, the measure of the gift would be reduced not only by applicable minority and marketability discounts but also by the value (computed under §7520) of the annuity interest retained by the taxpayer. In order to achieve the reduction in value for the taxpayer's reserved annuity payments, the right to receive these payments must constitute a "qualified interest" under §2702(b) which requires that the interest retained by the grantor consist of the right to receive fixed amounts payable not less frequently than annually (or a fixed percentage of the fair market value of the property in the trust determined annually).

Since the annuity payments to the taxpayer/grantor must be paid annually, a GRAT will generally work best when income producing property is placed in the trust. However, it is also possible to satisfy the annuity payments by distributions "in kind" of portions of the partnership interest.
a. There is one major downside to the transfer of an interest in a family partnership to a GRAT. If the taxpayer dies prior to the expiration of his annuity period, a portion or all of the property held in the trust will be included in his estate for federal estate tax purposes.

(1) If the trust property is includible under §2036, then only the portion of the property necessary to pay the annuity payment should be includible. However, the Service views such trusts as includible under §2039, which requires that the entire value of the property be included in the taxpayer's estate. See, PLR 9345035.

(2) Another potential disadvantage of a GRAT is the treatment accorded GRATs for generation skipping tax purposes. Under §2642(f), the value reduction for the grantor's retained interest which is allowable for gift tax purposes under §2702 will not be available for GST tax purposes. Section 2642(f) defers the deemed transfer until the expiration of the taxpayer/grantor's retained income interest. Thus, the transfer of an interest in a family partnership to a GRAT for the benefit of a grandchild is not generally advisable.

b. If the GRAT generates income in excess of the amount necessary to fund the annuity payment to the taxpayer, the excess income will be retained in the trust and will ultimately pass to the taxpayer's children. However, since the trust is usually a "grantor trust" for federal income tax purposes, all of the income of the trust will be taxed to the taxpayer/grantor. Thus, the taxpayer/grantor will bear the income tax cost for the accumulation of any excess income for the benefit of his children. This effectively provides the taxpayer/grantor with the ability to make additional transfers for the benefit of his children without gift tax cost.
However, the Service has recognized this situation and now requires that any GRATs submitted for a favorable ruling contain a provision which both authorizes and requires the GRAT to make distributions to the taxpayer/grantor in excess of his annuity amount to the extent necessary to cover the tax for any excess income earned by the GRAT during the term of his income interest. See, e.g., PLR 9504021 (10/28/94)

2. **Split Purchase of Partnership Interest by Taxpayer and Child.** A method that has occasionally been used for the acquisition of real estate or securities and which may, under certain circumstances, be employed in connection with the acquisition of an interest in a family partnership, is a split purchase. In a split purchase, a taxpayer would acquire a portion of the rights with respect to the partnership interest for either a fixed term of years or for his life, and the remainder interest (i.e., the rights to the partnership interest after the expiration of the taxpayer’s term) would be acquired by his child. Under §2702(c), such a purchase must now be viewed as a transfer of interest in a trust. §2702(c)(1). Section 2702(c)(2) then employs the same "subtraction methodology" used for GRATs by treating the taxpayer as having acquired the entire interest in the trust and then having transferred the remainder interest to his child. The pertinent statutory analysis is as follows:

a. Section 2702(a) provides that when a person transfers an interest in trust to (or for the benefit of) a member of his family, and the transferor retains an interest in the trust, the value of the retained interest is zero for gift tax purposes, unless the transferor retains a "qualified interest."

b. The definition of a "qualified interest" under §2702(b) includes a "qualified annuity interest." If an interest meets the qualified interest requirements, it will be valued under §7520. §2702(a)(2)(B). The value of the qualified term interest so determined will be
deducted from the value of the entire property subject to the transfer; the difference will be the value of the transferred remainder interest.

c. The requirements for a qualified annuity interest are found in Reg. §25.2702-3. Reg. §25.2702-3(b)(1) provides that a qualified annuity interest is an irrevocable right to receive a fixed amount. A fixed amount is defined in Reg. §25.2702-3(b)(1)(ii)(B) as a fixed fraction or percentage of the initial fair market value of the property transferred, payable annually. Adjustments to the amount of distributions are also required under Reg. §25.2702-3(b)(2) for incorrect determinations of the initial fair market value of the transferred property. In addition, Reg. §25.2702-3(b)(3) states that the requirements of Reg. §1.664-2(a)(1)(iv) governing charitable remainder annuity trusts (relating to short taxable years and the final taxable year of the life tenant’s term) must be met in computing the annuity amount. Reg. §25.2702-3(d)(2) prohibits distributions to anyone other than the annuitant during the term of the qualified interest. Finally, Reg. §25.2702-3(d)(4) also prohibits prepayment of the termholder’s interest.

d. Under §2702(c)(2), if two or more members of the same family acquire interests in any property, the person acquiring the term interest in such property shall be treated as having acquired the entire property and then transferred to the other owners the interests acquired by them in the transaction. Section 2702(c)(2) provides that such transfers to the other persons shall be treated as made in exchange for consideration, if any, provided by such other persons for the acquisition of their interests in such property. Thus, applying the valuation rules of §2702(a) to the deemed transfer described in §2702(c)(2), if the term interest in such property constitutes a qualified interest which is to be valued under §7520, the purchaser of the term
interest will not be deemed to have made a gift to the purchaser of the remainder interest unless the residual value of the property (i.e., the value of the entire property less the value of the qualified interest as determined under §7520) exceeds the consideration paid by the remainder owner for his interest in the property.

e. The regulations do not deal directly with a qualified split purchase by family members of a specific property, but do so by implication in two separate examples. See, Reg. §25.2702-4(d), Ex. 1 and Ex. 2.

Exhibit B to this outline contains a favorable ruling recently obtained by the author of this outline on a split purchase by a father and daughter of an interest in a family partnership. Based upon the facts of the ruling, the interest acquired by the life tenant was deemed to constitute a "qualified annuity interest" under §2702, the value of which was to be determined under §7520 for federal gift tax purposes. Further, the ruling concluded that no portion of the life tenant's interest would be includible in his estate under §2036 at the time of his death. (An unfavorable ruling was also issued with respect to another family member and several family trusts because the remainder owners, which constituted minimally funded family trusts, were not deemed to have a sufficient economic role in the transaction.) This is a private letter ruling which was published on April 14, 1995 as PLR 9515039.
EXHIBIT "A"

FAMILY LIMITED PARTNERSHIP EXAMPLE

Lan Rich owns ten acres of undeveloped land just outside of the rapidly growing Orlando metropolitan area. Lan Rich's daughter, Penny Rich, and his son, Moe Rich, own a contiguous undeveloped tract consisting of ten acres which they inherited from their grandfather. Although the property is presently zoned for agricultural use, Mr. Rich believes the time is right for development of the combined parcels into a power center and entertainment complex to service the nearby residential areas.

In its undeveloped state, the combined 20-acre Rich parcels have an aggregate fair market value of $1,000,000. Lan Rich estimates that once the combined properties have been rezoned, planned and permitted and sufficient tenant commitments have been obtained to make the project viable, the property will have a value of approximately $2,500,000, and the property may have a value as high as $10,000,000 once the project is fully built out and leased.

Although Mr. Rich is both optimistic and excited about the prospects of the new project, he also has a sizable net worth and is concerned about the possible impact upon his estate of the expected future appreciation in value. He views this project as a long term business opportunity for himself, his two children and his grandchildren and he desires to pass his interest in the project to his family members with minimum attrition from federal estate, gift and generation skipping taxes.

Pursuant to the advice of the Riches' tax attorney, Sally Savy, Lan, Penny and Moe have determined to convey all their interest in the subject properties to a newly formed family limited partnership. Each will receive a 3-1/3% interest as a general partner and a 30% interest as a limited partner. Lan Rich is designated as the managing general partner with control of day-to-day operations of the partnership, but major business decisions such as the sale or exchange of all or a substantial portion of the properties, the placement of a mortgage on the properties or other decisions that could reasonably be expected to have a major impact on the project will require the consent of a majority of the general partners. The partnership will have a stated term of 75 years and no general partner will have the unilateral right to terminate the partnership before the expiration of the stated term. However, the partnership can be terminated prior to the expiration of the 75-year term with the unanimous consent of the general partners and the
approval of limited partners holding not less than a majority of the percentage interests in the partnership. No limited partner will be permitted to withdraw from the partnership prior to the expiration of the stated term. Limited partners will be permitted to transfer all or a portion of their limited partnership interests to family members or to trusts for the sole benefit of such family members. If a limited partner desires to transfer all or a portion of his limited partnership interest to persons other than family members or a family trust, the interest which is proposed to be transferred will be subject to rights of first refusal exercisable first by the other partners and secondarily by the partnership. Any transferee of a limited partnership interest, whether a family member (or a family trust) or a third party, will become an "assignee partner" unless all of the partners vote to make such transferee a substitute limited partner.

Lan Rich intends to make gifts of a portion of his limited partnership interests both to his children and grandchildren (within the applicable GST exemption amount) as soon as possible after formation of the partnership. Pursuant to the advice of Sally Savy, the Riches retained the services of a well qualified MAI appraiser to appraise the value of the real properties, and a qualified business appraiser to establish the value of the limited partnership interests which will be gifted.
Re: SSN:

Legend:
Taxpayer A =
Taxpayer B =
Trusts =
Daughter =
Venture =
Family Entity =

Dear

This is in response to your memorandum dated January 5, 1995, and prior correspondence on behalf of Taxpayers concerning the application of section 2702 of the Internal Revenue Code.

The facts, as submitted, indicate that Taxpayer A has agreed to participate as a limited partner in Venture, a Florida limited partnership created to construct and operate a commercial facility solely with equity contributed by the partners; i.e., without acquisition or construction financing. None of the other investors in Venture are related to Taxpayers.

Taxpayer A, Taxpayer B (Taxpayer A’s child), other individuals related to Taxpayer A, and certain trusts for the benefit of individuals related to Taxpayer A, propose to create Family Entity (a Florida general partnership) to acquire the limited partnership interest in Venture. The acquisition of two of the Family Entity interests, representing 35.33 percent of the investment, will involve substantially identical joint purchase agreements [agreements].

One agreement involving Taxpayer A and Daughter (another of A’s children) will involve a 28 percent interest in Family Entity. Taxpayer A and Daughter will each provide from their
independent funds that portion of the purchase price corresponding to his or her actuarial interest as determined under § 7520. Daughter possesses independent wealth substantially in excess of that necessary to purchase the remainder interest.

Taxpayer A and his wife, in contemplation of this investment, have created three trusts for the benefit of Taxpayer B's issue. Taxpayer B and those trusts will enter into the second agreement involving a 7.33 percent interest in Family Entity. Substantially all of the corpus of the trusts will be used to acquire the remainder interest.

The governing instrument of Family Entity provides for priority annual distributions to each interest holder on or before February 15 of each year equal to nine percent of the initial cash contribution of that interest holder, but only to the extent such distributions are not prohibited by applicable law and only to the extent funds are available. The instrument also requires additional distributions from any "distributable cash" in excess of that needed to make the priority distributions. The term "distributable cash" essentially refers to cash flow less certain reserves.

If Family Entity is unable in any year to distribute an amount equal to nine percent of the initial contribution to the interest holders, the governing instrument requires that Family Entity issue notes, payable on demand, bearing a market rate of interest in lieu of the undistributed portion of such payment.

Other provisions of the governing instrument applicable to the interests subject to the agreements provide that:

1) The interests may not be sold during the life of the life tenant;
2) The Family Entity is to continue in existence at least until the death of the last to die of Taxpayers A and B;
3) No additional capital contribution will be required of Taxpayer A or Taxpayer B; and
4) Any payment required to be made by Taxpayer A or Taxpayer B to a creditor of the entity is to be treated as a loan to the entity to be repaid out of the first available proceeds, with interest to be paid at the prime rate determined by a specified regional bank.

In addition, the governing instrument requires that loss allocations that would result in a negative balance in the capital account of the interests subject to the joint purchase agreement are to be allocated to interests other than those subject to the agreements.
Under the terms of their respective agreements, Taxpayer A and Taxpayer B are designated as life tenants and, thus, will be entitled to receive any distributions made by Family Entity with respect to the interests subject to the agreements.

Taxpayers propose that the agreements will be effective on February 1, 1995. Their respective agreements will provide that, on January 31, Taxpayer A and Taxpayer B will be entitled to receive, with respect to each preceding 12 months, payments equal to the greater of nine percent of the total initial purchase price or the aggregate distributions made by Family Entity with respect to the interest during such preceding period. In the event Family Entity issues a demand note in lieu of the nine percent payment contemplated by the agreement, the owner of the remainder interest under each agreement agrees to promptly execute and deliver a full recourse written guarantee of payment.

Each agreement further provides that no other persons will be entitled to receive distributions during the life tenant's life. Special rules in each agreement require appropriate adjustments in the case of incorrect valuation or in the event of a payment with respect to a period of less than one year. Commutation of the life tenant's interest is specifically prohibited.

You request the following rulings.

1. The interest to be acquired by Taxpayer A as life tenant under the agreement will be a qualified annuity interest under § 2702 the value of which is determined under § 7520 for federal gift tax purposes.

2. The interest to be acquired by Taxpayer B as life tenant under the agreement will be a qualified annuity interest under § 2702 the value of which is determined under § 7520 for federal gift tax purposes.

3. The interest to be acquired by Taxpayer A as life tenant under the agreement will not be included in Taxpayer A's gross estate for under § 2036 solely by reason of the agreement.

4. The interest to be acquired by Taxpayer B as life tenant under the agreement will not be included in Taxpayer B's gross estate for under § 2036 solely by reason of the agreement.

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2511 provides that the tax imposed by § 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.
Section 2702 provides the method for valuing a gift in trust when the gift is to or for the benefit of a member of the transferor’s family and the donor or an applicable family member retains an interest in the gifted property. Section 2702(a)(2) provides that, in general, the value of any retained interest that is not a qualified interest shall be treated as being zero. The value of any retained interest that is a qualified interest shall be determined under § 7520.

Section 2702(c)(1) provides that the transfer of an interest in property with respect to which there are one or more term interests shall be treated as the transfer of an interest in a trust. Section 2702(c)(2) provides that, if two or more members of the same family acquire interests in such property (property described in paragraph (1)) in the same transaction (or a series of related transactions), the person acquiring the term interest in such property is treated as having acquired the entire property and then transferred to the other persons the interests actually acquired by them in the transaction. Such transfer shall be treated as made in exchange for the consideration, if any, provided by such persons for the acquisition of their interests in the property.

Section 25.2702-1(b) of the Gift Tax Regulations provides that, if § 2702 applies, the amount of the gift is determined by subtracting the interest retained by the transferor or any applicable family member from the value of the transferred property. If the retained interest is not a qualified interest and, thus, is valued at zero, the amount of the gift is the entire value of the property. If the retained interest is a qualified interest, then the value of the gift will be the fair market value of the property transferred to the trust less the value of the qualified interest.

Section 25.2702-2(a)(5) provides that a qualified interest includes a qualified annuity interest. A qualified annuity interest is an interest that meets all the requirements of §§ 25.2702-3(b) and (d).

Among other requirements, under § 25.2703-3(b), a qualified annuity interest must be an irrevocable right to receive a fixed amount payable at least annually. A fixed amount means either 1) a stated dollar amount payable periodically, but not less frequently than annually, but only to the extent that the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year, or 2) a fixed fraction or percentage of the initial fair market value of the property transferred to the trust as finally determined for federal tax purposes, payable periodically, but not less frequently than annually, but only to the extent that the fraction or percentage does not exceed 120
percent of the fixed fraction or percentage payable in the preceding year. The governing instrument must prohibit additional contributions after the establishment of the trust.

Section 25.2702-3(b) also provides that the annuity amount must be payable to or for the benefit of the holder of the annuity interest for each taxable year of the term. A payment with respect to any taxable year may be made after the close of such taxable year provided the payment is made 1) within the 12 month period and 2) no later than the date by which the trustee is required to file the federal income tax return of the trust for the taxable year without regard to extensions.

The regulations also provide that, the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iv) of the Income Tax Regulations relating to the computation of the annuity amount in the case of short taxable years and the last taxable year of the term. Section 1.664-2(a)(1)(iv) provides that in the case of a short taxable year and the year of termination of the trust, the annuity amount shall be prorated on a daily basis for the number of days making up the short taxable year or the period from the beginning of the taxable year to the date of termination of the trust. However, an instrument is deemed to meet these short taxable year requirements if it provides that the fixed amount or a pro-rata portion thereof must be payable for the final period of the annuity interest.

If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iii) (relating to the qualification of charitable remainder annuity trusts) providing for any incorrect determination of the fair market value of the property in the trust. Section 1.664-2(a)(1)(iii) provides that, if the market value is incorrectly determined by the fiduciary, the governing instrument must provide that the trust shall pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient.

Section 25.2702-3(b) specifically states that a right of withdrawal, whether or not cumulative, is not a qualified annuity interest.

Section 25.2702-3(d) provides additional requirements applicable to qualified annuity interests. In general, to be a qualified annuity interest, an interest must be a qualified
annuity interest in every respect. The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity interest during the term of the qualified interest. The governing instrument must fix the term of the annuity interest. This term must be for the life of the term holder, for a specified term of years, or for the shorter, but not the longer, of those periods. The governing instrument must prohibit commutation (prepayment) of the interest of the term holder.

Section 2033 provides that the value of a decedent's gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2036(a) provides, in part, that the value of the gross estate shall include the value of property to the extent of any interest therein of which the decedent has at any time made a transfer (except for full and adequate consideration in money or money's worth) by trust or otherwise, under which the decedent has retained for life or for any similar period, the possession or enjoyment of, or the right to the income from, the property.

However, if the decedent at no time held any interest in property other than a life interest which terminates at the decedent's death, no portion of the value of the property is includible in the decedent's gross estate as property in which the decedent had an interest or as the subject of a transfer with a retained life estate. See Rev. Rul. 66-86, 1986-1 C.B. 216.

Similarly, if a decedent has transferred property to another in return for a promise to make periodic payments to the transferor for the transferor's lifetime, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent under § 2036. In these cases, the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made. See Rev. Rul. 77-193, 1977-1 C.B. 273, and cases cited therein.

Section 2043(a) provides that if any one of the transfers, trusts, etc. enumerated in §§ 2035 to 2038 is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for and adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.
In the present case, several members of the same family are acquiring interests in Family Entity in the same transaction. In transactions that are part of that transaction, yet separate and distinct therefrom, family members are acquiring interests in property in which there are term interests. With respect to those separate transactions, § 2702 requires that Taxpayer A be treated as having acquired the entire 28 percent interest in which he has a term interest and then having transferred the remainder interest in that 28 percent interest in trust to Daughter. Similarly, § 2702 requires that Taxpayer B be treated as acquiring the 7.33 percent interest and transferring the remainder interest in that interest in trust to the trusts created for Taxpayer B's issue.

Analysis of the facts indicates that Family Entity functions as a solely as a conduit, channeling cash flow from Venture to the members of the family. In any year when Venture fails to generate cash flow equal to nine percent of the initial contributions, Family Entity will issue demand notes to the various interest holders entitled to payment. Those notes can only be satisfied out of future cash flow that is distributable to the interest holder in any event. Thus, the notes, standing alone, represent nothing more than a cumulative right of withdrawal of assets otherwise distributable to the interest holder.

The terms of each agreement provide that:

1) The life tenant is to receive on an annual basis, nine percent of the total amount contributed with respect to the interest subject to the agreement;
2) The first payment will be made within twelve months of the deemed transfer to the trust; and
3) In the event that a note is distributed to the life tenant, the remainderman will guarantee payment of the note, on demand, with full recourse to the independent assets of the remaindernen.

In addition, other terms in the agreement satisfy the remaining requirements of §§ 25.2702-3(b) and (d) of the regulations.

Ruling requests 1 and 2:

Based on the above we conclude that:

1) Because Daughter has sufficient independent wealth to provide assurance that Taxpayer A will be entitled to receive the entire series of annuity payments without regard to the success of Venture, the notes, if issued, will not be considered a mere
right of withdrawal of trust assets and, thus, the interest to be acquired by Taxpayer A as life tenant under the agreement will be a qualified annuity interest under § 2702, the value of which is determined under § 7520 for federal gift tax purposes.

2. Because Trusts are entities holding no assets other than the remainder interest, the obligation to make the payments is satisfiable solely out of the underlying property and its earnings. Thus, the interest retained by Taxpayer B under the agreement, being limited to the earnings and cash flow of Venture, will not be a qualified annuity interest under § 2702.

Ruling requests 3 and 4:

Taxpayer's representative argues that the acquisition of the life estate and remainder interests in the 28 and 7.33 percent interests should be viewed as a "joint purchase" wherein Taxpayers independently acquired their interests as "life tenants" while the remaindermen separately acquired their interest. Under this scenario, they argue, neither Taxpayer A nor Taxpayer B can be said to have made a transfer of property in which they retained an interest that would cause inclusion in the value of their gross estate under § 2036.

We disagree. It is clear from even a cursory examination of the terms of these agreements that the respective interests of the Taxpayers differ substantially from a typical life tenant/remainderman situation. It would be unusual, for example, for the life tenant to receive distributions that represent a return of capital. Similarly, it would be unusual for the remaindeman to pledge his or her independent assets to assure that the return payable to the life tenant attained the anticipated level.

We think the better analysis is that each taxpayer has made a transfer of property in a transaction under which that Taxpayer has retained the right to receive periodic payments for the transferor's lifetime.

Under Rev. Rul. 77-193, supra, it is apparent that these payments do not represent a retained interest in the transferred property so as to include the property in the estate of the transferor (under § 2036) so long as the promise is a personal obligation of the transferee, the obligation is not satisfiable solely out of the underlying property and its earnings, and the size of the payments is not determined by the size of the actual income from the underlying property at the time the payments are made.
Based on the above, and with reference solely to the terms of the agreements, we conclude:

3. Because Daughter holds sufficient personal wealth to satisfy her potential personal liability for the payments to Taxpayer A, and because neither the size nor the obligation to make those payments relates to the performance of the underlying property, the interest to be acquired by Taxpayer A as life tenant under the agreement will not be included in Taxpayer A's gross estate for under § 2036 solely by reason of the agreement.

4. Because Trusts are entities holding no assets other than the remainder interest, the obligation to make the payments is satisfiable solely out of the underlying property and its earnings. Thus, the interest retained by Taxpayer B under the agreement, being limited to the earnings and cash flow of Venture, will cause the inclusion of the value represented by the 7.33 percent interest to be includible in Taxpayer B's gross estate under § 2036 (reduced pursuant to § 2043, by the amount of consideration furnished by Trusts at the time of the purchase).

Except as we have specifically ruled, we express no opinion as to tax consequences of the proposed transaction under §§ 2036, 2039, or any other provisions of the Code.

This ruling is based on the facts and applicable law in effect on the date of this letter. If there is a change in material fact or law (local or federal), the ruling will have no force or effect. If Taxpayer is in doubt whether there has been a change in material fact or law, a request for reconsideration of this ruling should be submitted to this office.
This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

A copy of this letter should be attached to any gift, estate or transfer tax returns that you may file relating to these matters.

Sincerely yours,

Assistant Chief Counsel
(Passthroughs and Special Industries)

By ___________________________
Lee A. Dunn
Acting Chief, Branch 4

Enclosure:
Copy for Section 6110 purposes