

Holman v. Commissioner

Eighth Circuit Affirms Tax Court's Application of Section 2703 to Transfer Restrictions in Partnership Agreement and Its Finding of Low Marketability Discount Based Partly on Assumption That Remaining Partners Would Purchase an Exiting Partner's Interest, Holman v. Commissioner, 105 AFTR 2d ¶ 2010-1802 (8th Cir. April 7, 2010) aff'g 130 T.C. 170 (2008)

Fisher v. United States

District Court Grants Partial Summary Judgment for Government Providing that Transfer Restrictions in LLC Agreement Were to Be Disregarded in Valuing Member Interests, Relying on Holman, Fisher v. United States, 106 AFTR 2d ¶ 2010-6144 (S.D. Ind. September 1, 2010)

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Synopsis of Holman:

A retired Dell employee and his wife created an FLP to hold some of their Dell stock, and made gifts of limited partnership interests in 1999, 2000, and 2001. The agreement contained commonly used transfer restrictions, restricting transfers of LP interests without approval of all partners, and giving the partnership the right to purchase non-permitted assignments at the fair market value based on the right to share in distributions (i.e., considering discounts) of those assignee interests. The Tax Court rejected the IRS argument that the gift of LP interests six days after the partnership was created was an indirect gift of a proportionate part of the assets contributed to the partnership (i.e., without a discount), and the IRS did not appeal that decision. The 8th Circuit Court of Appeals (by a 2-1 split of the three-judge panel) affirmed the Tax Court's conclusion that transfer restrictions in the agreement must be ignored under §2703 in valuing the transfers. (The court reasoned that the transfer restrictions did not satisfy the “bona fide business arrangement” requirement in the §2703(b) safe harbor.) The Tax Court valued the transferred LP interests by applying combined lack of control and marketability discounts of 22.4%, 25%, and 16.25% in 1999, 2000, and 2001, respectively. The lack of marketability discount was only 12.5%, partly based on a consideration that the remaining partners would have an economic interest to purchase an interest for a value somewhere between the discounted price that a third party was willing to pay and a pro rata share of net asset value, thus placing a floor on the marketability discount. The 8th Circuit affirmed that approach and held that it did not violate the hypothetical willing buyer/willing seller valuation standard. The taxpayer's request for an *En Banc* review of the case by the full Eighth Circuit was denied.

There was a strong dissent as to both the §2703 and the marketability discount issue.

The case overall is still a taxpayer victory — gifts were made of a partnership interests holding only one marketable stock with a 22.4% discount for the most significant gift. The taxpayers were able to avoid losing all discounts by defeating the IRS's indirect gift/step transaction argument in the Tax Court. Some of the reasoning in the case, however, is quite troubling for planners if future courts follow the same approach of this Tax Court (regular opinion, not just a Memorandum decision) and 8th Circuit case:

- Section 2703 will likely not allow considering transfer restrictions in valuing FLP interests for most investment partnerships because of the strict test for meeting the “bona fide business arrangement” requirement of the §2703 safe harbor where there is not an operating business;
- The Tax Court's reasoning (which was not addressed by the 8th Circuit) for concluding that the “device” requirement of the §2703 safe harbor was not met (because of the “redistributive effect” of purchasing an interest in the entity at less than pro rata value of the entire entity) would suggest that many buy-sell agreements for even operating businesses with family members as owners would not be respected for transfer tax valuation purposes;
- The government's appraiser (Francis Burns) believed that the right of first refusal provision (allowing the partnership to purchase an interest using a 10-year note with an interest rate equal to the applicable federal rate) would have generated about an additional 15% discount; he believed that the overall discount with the transfer restriction included was 31.6% but only 16.9% if the transfer restriction were disregarded; the taxpayer's expert believed that the transfer restriction added only an additional 2.4% discount; and
- The reasoning suggests a major inroad on the hypothetical willing buyer/willing seller valuation standard by taking into consideration that remaining partners would likely purchase the interest of any exiting partner at a price higher than what a third party would pay; the 12.5% marketability discount is very low and IRS agents may be citing this case routinely in future audits to support a low marketability discount.

Basic Facts of Holman:

1. On November 2, 1999, parents created an FLP by transferring some of their Dell stock to the partnership. Parents were the general partners (0.89% each) and they owned 98.08% of the FLP as limited partners. (In addition, a trust for children contributed some Dell stock for a very small [0.14%] LP interest.)
2. The parents intended to make gifts of LP interests when they created the partnership. Husband's primary purpose for the partnership was to preserve his Dell wealth and "disincentivize" his children from spending it. Wife's primary purpose was to use the partnership to educate children about basic investing principles and about the responsibility attendant to family wealth. Potential gift tax savings from valuation discounts "played a role" in the decision to form the FLP.
3. The partnership agreement contained transfer restrictions commonly found in partnerships. The agreement prohibited limited partners from transferring "all or part" of their interests without the consent of all partners (paragraph 9.1); however, transfers to certain family members were allowed (paragraph 9.2). If a purported prohibited transfer were deemed to be effective, the partnership would have the right to purchase the non-permitted assignment at fair market value to be determined by an appraiser selected by the General Partner based on the right to share in distributions (presumably, taking into account appropriate discounts, and the value based on the right to share in distributions might be lower than just "fair market value" (but the court did not emphasize that factor); the purchase price could be paid with a 10% down payment and a 5-year note for the balance bearing interest at the Applicable Federal Rate (paragraph 9.3). Section 12.1 provides that the partnership may be dissolved by the written consent of all partners.
4. Six days after the partnership was created (i.e., on November 8), parents made gifts of 70.06% of the LP interests to the trust for their children (and partly to a custodianship for one child, in order to equalize their prior gifts to custodianships for their other children).
5. About two months later (on January 4, 2000), parents made additional annual exclusion gifts of LP interests to the trust for their four daughters (which they thought were worth \$80,000, after applying a 49.25% discount).
6. The following year (on January 5, 2001), the parents contributed more Dell stock to the partnership in return for more LP units, and about a month later (on February 2) they made additional annual exclusion gifts of LP units to custodianships for their four daughters (which they thought were worth \$80,000, after applying a 49.25% discount).
7. In the gift tax audit, the IRS initially offered a 28% discount. When the case proceeded to trial, the IRS obtained an appraisal and took the position that the discount should be lower than that.
8. The Tax Court held that the gifts made six days after the FLP was formed cannot be viewed as an indirect gift of the shares contributed to the FLP under the gift tax regulations or under the step transaction doctrine. The critical factor regarding the step transaction argument was that there was a "real economic risk of a change in value" between the time of funding of the partnership and the date of the gift six days later. The IRS did not appeal that finding.

The Tax Court held that transfer restrictions in the agreement must be ignored under §2703 in valuing the transfers. The "bona fide business arrangement" requirement and the "device" requirement in the §2703(b) safe harbor were not satisfied. (As to the comparability test in §2703(b), the Tax Court acknowledged that the experts agreed that the transfer restrictions in the Holman partnership agreement are common in agreements entered into at arm's length. Because the first two tests in the safe harbor were not met, the court said that it did not need to address a

novel argument by the IRS that overall circumstances make it unlikely that arm's length third parties would agree to any of the restrictions because third parties would not "get into this deal with the Holmans, period.")

The Tax Court generally adopted the IRS's appraiser's opinion in valuing the donated interests. A lack of marketability discount of only 12.5% was allowed, based on the appraiser's analysis of the difference in discounts that were applied to purchases during different time periods when institutional investors were and were not allowed to buy restricted stock during the Rule 144 holding period for the stock. The small discount was not adjusted upward for other possible factors because the partners can agree to dissolve the partnership at any time and there would be an economic interest to both a limited partner wanting to exit the partnership and the remaining partners "to strike a deal at some price between the discounted value of the units and the dollar value of the units' proportional share of the partnership's NAV."

9. The taxpayers appealed the §2703 and valuation holdings.

Issues in Holman:

1. Section 2703. Does §2703 preclude considering the transfer restrictions in the partnership agreement in determining the value of the gifts of the limited partnership interests?
2. Valuation. What is the appropriate marketability discount? (More specifically, is the hypothetical willing buyer/willing seller valuation standard violated by considering that partners in the partnership would have an incentive to purchase the interest of an exiting partner at a price between pro rata net asset value and the value that a third party would pay for the interest to reach a conclusion limiting the marketability discount?)

Holdings in Holman:

The majority opinion (Judges Melloy and Gruender) affirmed the Tax Court.

1. Transfer restrictions in the partnership agreement are disregarded for valuation purposes, under §2703(a), and the §2703(b) safe harbor does not apply because the bona fide business arrangements requirement is not satisfied.
2. The 12.5% lack of marketability discount was based in part on the fact that the ability of the remaining partners to purchase assigned interests set a natural limit on any discounts. That did not violate the hypothetical willing buyer/willing seller valuation standard because it "comports with the general rule of casting the potential buyer merely as a rational economic actor."

A strong dissent (Judge Beam) disagreed with both of those holdings and would have reversed and remanded to the Tax Court for a new marketability discount determination.

Analysis in Holman:

1. Section 2703 — Majority Opinion.
 - a. Statute and Safe Harbor Exception. Section 2703(a) provides that the value of any property transferred is determined without regard to any right or restriction related to the property. (The parties agreed that the transfer restrictions constitute restrictions on the right of a limited partner to sell or assign her partnership interest.) Section 2703(b) provides a safe harbor from the application of §2703(a) if each of three requirements are satisfied: (i) It is a bona fide business arrangement; (ii) It is not a device to transfer such property to members of the decedent's family [the regulations refer to "natural objects of the transferor's bounty" to make clear that §2703 applies to gifts as well as death

transfers] for less than full and adequate consideration in money or money's worth; and (iii) Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

(The taxpayer argued that the literal language of the second requirement of the safe harbor (the "device" test in §2703(b)(2)), which refers to the "decedent's family," should not apply to inter vivos gifts. The Tax Court rejected that argument, observing that the taxpayers did not object to the validity of the regulation's reference to "natural objects of the transferor's bounty.")

b. Flunks Bona Fide Business Arrangement Requirement. The 8th Circuit agreed with the Tax Court that the transfer restrictions in the partnership agreement do not satisfy the bona fide business arrangement requirement in the §2703(b) safe harbor. Accordingly, the 8th Circuit affirmed the Tax Court's conclusion that §2703(a) precluded consideration of the transfer restrictions in determining the value of the transferred limited partnership interests.

(1) Clear Error Review. The opinion viewed this as a question of fact to be reviewed for clear error.

(2) Tax Court Reasoning. The Tax Court acknowledged that the bona fide business arrangements requirement does not necessarily require an actively managed business. However, the fact that this case did not involve a closely held business seemed important to the Tax Court's reasoning. The Tax Court discussed Estate of Amlie, legislative history, and cases recognizing that maintaining control of a closely held business constitutes a bona fide business arrangement. It concluded its analysis:

"There was no closely held business here to protect, nor are the reasons set forth in the Committee on Finance Report as justifying buy-sell agreements consistent with petitioners' goals of educating their children as to wealth management and 'disincentivizing' them from getting rid of Dell shares, spending the wealth represented by the Dell shares, or feeling entitled to the Dell shares."

[Observe: The Senate Finance Committee Report to which the Tax Court referred also included the following as one of the "legitimate business reasons" contemplated within the §2703 exception: "to prevent the transfer to an unrelated party." The Tax Court did not address why that phrase in the Senate Finance Committee report did not apply in this case.]

(3) Appropriate Standard For Investment Partnerships. The majority opinion repeatedly rejected the taxpayer's argument that the Tax Court's restrictive interpretation of the phrase "business arrangement" effectively imposed an "operating business nexus" or requirement that the underlying partnership be an actively managed enterprise. [Observation: The court made that comment repeatedly, to the point that it seemed the majority was overly sensitive to this criticism of its analysis. "Thou dost protest too much" comes to mind in reading the opinion.] The opinion also rejected the taxpayer's argument that the nature of the assets in a partnership is irrelevant for determining whether transfer restrictions constitute a bona fide business arrangement.

[Observation: The issue of whether the nature of the partnership assets is relevant to this “bona fide business arrangement” test seems crucial because the 8th Circuit itself has previously held that “maintenance of family ownership and control of [a] business” may be a bona fide business purpose. St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982).]

The majority opinion in effect adopts the Tax court’s approach that there must be a bona fide business purpose not just for the transfer restriction at issue but it clearly looks to the business purposes of the entity and the nature of the assets in the entity in applying this test:

“We agree with the Tax Court’s conclusion and reject the donor’s attempt to characterize the Tax Court’s opinion as creating an ‘operating business nexus.’ In answering the question of whether a restriction constitutes a bona fide business arrangement, context matters. Here that context shows that the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions. Simply put, in the present case, there was and is no ‘business,’ active or otherwise. The donors have not represented any argument or asserted any facts to distinguish their situation from the use of a similar partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash. We and other courts have held that ‘maintenance of family ownership and control of [a] business’ may be a bona fide business purpose. [Citations omitted.] We have not so held, however, in the absence of a business.”

The majority opinion continued on to isolate the *specific factors* that caused this investment partnership not to meet the bona fide business arrangement test. These factors relate to the nature and purposes of the partnership itself rather than the purposes of the transfer restriction.

“That is not to say we necessarily believe it will always be easy to apply §2703(b)(1) or that investment-related activities cannot satisfy the subsection (b)(1) test. When the restrictions at issue, however, apply to a partnership that holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy, we do not view this determination as difficult.”

The court’s concluding sentence of the bona fide business arrangement issue, quoted in subparagraph (6) below, also gives insight to factors that will *not* satisfy the bona fide business arrangements requirement for investment partnerships: “purposes of estate planning, tax reduction, wealth transference, protection against dissipation by the children, and education for the children.”

- (4) Distinguish Amlie and Bischoff. The taxpayer argued that the Amlie and Bischoff cases illustrate that there can be a bona fide business arrangement under §2703(b)(1) even for investment assets (i.e., a minority interest in a closely held bank and a holding company limited partnership, respectively). The majority opinion distinguished Estate of Amlie v. Comm’r, T.C.M. 1017 (2006) because its purpose was to enhance the liquidity of an otherwise illiquid asset (a minority interest in a closely held bank), but the Holman partnership held Dell stock, which was easily valued and highly liquid. In Estate of Bischoff v. Comm’r, 69 T.C. 32 (1977), maintaining family ownership and control of a partnership was a

legitimate business consideration. However, the majority opinion noted that the primary asset of the partnership was a pork processing business managed by three families who wanted to avoid outside influence, and gave reasons distinguishing that from the Holman situation.

- (5) Section 2036 Cases. The taxpayer argued that the issue is analogous to the Schutt, Murphy, and Black cases, which all recognized the family’s desire to perpetuate an investment model or strategy as a “legitimate and significant non-tax purpose” for purposes of the bona fide sale exception in § 2036. Estate of Black v. Comm’r, 133 T.C. 15 (2009); Estate of Murphy v. United States, No. 07-CV-1013 (W.D. Ark. Oct. 2, 2009); Estate of Schutt v. Comm’r, 89 T.C.M. 1353 (2005). The court observed that these are arguably “the strongest cases for the donors,” but the court viewed those cases as “more nuanced” than merely concluding that holding investments for gain satisfies the “bona fide business arrangement” test. The cases involved situations where the objective was to preserve a “very specific investment strategy,” and in Schutt the Tax Court noted that “the mere holding of an untraded portfolio of marketable securities weighs negatively in the assessment of potential nontax benefits.” The court viewed the Holman partnership as “a mere asset container” (referencing the Tax Court’s distinguishing of the Schutt case in Estate of Erickson v. Comm’r, 93 T.C.M. 1175 (2007)). “Here, then unlike Schutt, the family membership, educational, and tax-reduction purposes overshadow any claim of a business purpose for the restrictions.”
 - (6) Defer to Judgment of Tax Court. Perhaps a key to the conclusion of the two judges in the majority of this three judge panel is the strong expression of its deference to the Tax Court:

“If anything, the important rule that we believe may be taken from Schutt and cases like it is that context matters such that it is appropriate to defer to the reasoned judgment and fact-finding ability of the Tax Court.”
 - (7) Summary of Majority Approach. “[T]here is little doubt that the restrictions included in the Holmans’ limited partnership agreement were not a bona fide business arrangement, but rather, were predominately for purposes of estate planning, tax reduction, wealth transference, protection against dissipation by the children, and education for the children.”
 - (8) No Reference to Legislative History. The taxpayer’s brief made extensive reference to the legislative history surrounding §2703 with various indications that the business arrangement test could be satisfied by the purpose of maintaining family ownership and control in situations involving receiving income from investment assets or the right to participate as a limited partner. The Tax Court opinion had at least quoted from the Senate Finance Committee Report (although it ignored the phrase in that report about preventing transfers to an unrelated party), but the majority opinion made no reference at all to the legislative history. The dissent (discussed below) emphasized the legislative history.
- c. No Discussion of Device Test. The Tax Court observed at the outset that the transaction was not a “device” to transfer the LP units for less than adequate consideration, in effect reiterating that §2703 is not being applied to disregard the entire partnership for valuation purposes. The issue is just whether the transfer restrictions constitute a device to transfer property to natural objects of the transferor’s bounty for less than full consideration.

The Tax Court concluded that the transfer restrictions constitute a “device” under rather strange reasoning. The court reasoned that the purpose of the transfer restrictions is to discourage the children from dissipating wealth. The transfer restrictions do that by depriving a child of realizing the difference between the fair market value of his LP units and the units’ proportionate share of the partnership’s NAV. Furthermore, if the partnership exercises its right to purchase a non-permitted assignment at the fair market value of the units (i.e., at their discounted value), it would be able to repurchase units at less than the proportionate NAV of the partnership, which, in turn, would increase the value of the interests of remaining partners (who would include natural objects of the parents’ bounty). The court believed that Mr. Holman

“understood the redistributive nature of paragraph 9.3. [i.e., the partnership’s purchase option] and his and Kim’s authority as general partners to redistribute wealth from a child pursuing an impermissible transfer to his other children. We assume, and find, that he intended paragraph 9.3 to operate in that manner, and this intention leads us to conclude, and find, that paragraph 9.3 is a device to transfer LP units to the natural objects of petitioners’ bounty for less than adequate consideration.”

The Tax Court’s analysis would cause §2703 to apply to this very common provision in most entities with family members as co-owners, including buy-sell agreements for operating businesses, and planners have hoped that this reasoning would be corrected on appeal. Unfortunately, the majority opinion does not address the device test at all; footnote 5 indicates that having resolved the “business arrangement” issue against the taxpayer, there was no need to address the additional requirements of the §2703(b) safe harbor. Therefore, the Tax Court analysis of the “device” test is left uncorrected.

d. Brief Reference to Comparability Test.

- (1) Tax Court Analysis. A law professor testified for the IRS and a practicing attorney who has participated in drafting or reviewing more than 300 limited partnership agreements testified for the taxpayer. Both agreed that “transfer restrictions comparable to those found in paragraphs 9.1 through 9.3 are common in agreements entered into at arm’s length.”

The Tax Court observed that this would seem to be all that the taxpayers need to show to satisfy the comparability test. However, the IRS’s expert had testified that the fact that these transfer restrictions were common in agreements entered into at arm’s length was irrelevant because “[t]he owners of a closely held business at arm’s length would never get into this deal with the Holmans, period, so the issue [transfer restrictions] wouldn’t come up.” (The expert pointed to the nature of the assets, the non-expertise of the general partner, the 50-year term, and the susceptibility of the single asset.) The IRS apparently argued that even if the specific transfer restrictions are comparable to restrictions in arm’s length arrangements, there is also an “overall circumstances” consideration as to whether arm’s length third parties would agree to any restrictions on sale or use of assets in the situation. In light of the fact that the Tax Court had already determined that the §2703(b) safe harbor did not apply (because neither the bona fide business arrangement test nor the device test were satisfied), the Tax Court concluded that “we need not (and do not) decide today whether respondent is correct in applying

the arm's length standard found in section 2703(b)(3) to the transaction as a whole.”

- (2) Majority Opinion Mention of Comparability Test. The majority makes no reference to the comparability test in the text of its opinion but goes out of its way, in footnote 5, to make clear that it did not believe the experts were as aligned on this issue as stated specifically by the Tax Court (and as noted by the dissent, discussed below) because the IRS expert said that the issue of transfer restrictions would not arise in the context of this partnership “because nobody at arm's length would get into this deal.” “Given this disagreement and the absence of a Tax Court ruling, we believe it is prudent not to address the §2703(b)(3) requirement on appeal.”

2. Section 2703 Issue — Dissent.

a. Dissent — Bona Fide Business Arrangement Test Satisfied.

- (1) Question of Law: Should be De Novo Review. The dissent maintained that the legal standard to satisfy the bona fide business arrangements test is a question of law because the fundamental question is whether the Tax Court “employed the correct criteria, framework, or test to make this factual determination.” At a minimum, it is at least a question of mixed law and fact. In either case, the court of appeals should review the decision de novo.
- (2) Legislative History. “Where, as here, the statute's language is ambiguous, it is appropriate to examine legislative history to determine legislative intent.”

The majority narrowly reads Bischoff, but congressional committees cited the case to support much broader propositions that maintaining family control is a legitimate business purposes for buy-sell agreements (1) “even when the ‘control’ being preserved is a right to receive income from investments” and even if the interest being sold is a “limited partnership interest in a holding company” (Joint Committee on Taxation staff report); and (2) “even when the ‘control’ being preserved is only the right to participate as a limited partner (Senate Finance Committee report).

The dissent quoted the Senate Finance Committee Report that was cited in Estate of Amlie:

“The committee believes that buy-sell agreements are common business planning arrangements and that buy-sell agreements generally are entered into for legitimate business reasons that are not related to transfer tax consequences. Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest and to allow owners to plan for future liquidity needs in advance.”

The dissent specifically noted the “preventing transfer to an unrelated party” factor in the Senate Finance Committee Report:

“The court majority's attempt to distinguish the present case from Amlie ignores that the *same portion of legislative history* cited by the Tax Court in Amlie, and quoted by the Tax Court in the present case, recognizes that buy-

sell agreements serve the legitimate businesses purpose of ‘prevent[ing] the transfer to an unrelated party.’ Finance Committee Report, 136 Cong. Rec. at 30,539. If the absence of an ‘actively managed business interest’ was irrelevant in Amlie, it is unclear why an actively managed business interest is required in the present case to legitimize the Holman partnership restrictions.”

- (3) Other Legitimate Purposes. The dissent noted various other “legitimate business purposes” of the transfer restrictions in the partnership agreement. It concluded:

“Thus, I would hold that the Holman partnership agreement restrictions are ‘bona fide business arrangements’ because they were not created for the primary purpose of avoiding taxes, and they served the following legitimate business purposes: (1) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnerships’ investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preserving the partners’ fundamental right to choose who may become a partner.”

- b. Dissent — Section 2703(b) Safe Harbor “Device” and Comparability” Tests. The dissent agrees with the taxpayer that the statutory language of the device test applies only to transfers by decedents, not to gifts, because it refers to transfer to “members of the *decedent’s* family.” Therefore, the dissent believed that the device test does not apply in this gift tax situation. (The Tax Court, in footnote 9 of its opinion, sidestepped that issue by reasoning that the taxpayer had failed to object to the validity of the regulation that refers to “natural objects of the transferor’s bounty” rather than “members of the decedent’s family.”)

The comparability test is met because the Tax Court “noted that both parties’ experts ‘agree that transfer restrictions comparable to those found in [the Holman partnership agreement] are common in agreements entered into at arm’s length.’” The majority opinion, in footnote 5, goes out of its way to make clear that the majority did not believe the experts were as aligned on this issue as suggested by the dissent because the IRS expert said that the issue of transfer restrictions would not arise in the context of this partnership “because nobody at arm’s length would get into this deal.” The dissent replied that “[a]t best, the cited emanations of this particular witness are barely relevant to a proper interpretation of this portion of the statute.”

3. Valuation; Appropriate Discounts.

- a. Lack of Control Discount Determination by Tax Court. Both experts determined lack of control discounts by reference to the prices of shares of publicly traded, closed end investment funds, which typically trade at a discount relative to their share of fund NAV, reasoning that the discounts must be attributable, at least to some extent, to a minority shareholder’s lack of control over the investment fund. There was a question as to what samples to include in the analysis, and the Tax Court used samples from the intersection of the experts’ data sets. There is also an interesting discussion of how to keep “outliers” in the samples from unduly impacting the conclusion. The taxpayer’s expert dealt with that concern by using the median sample (i.e., the sample for which half the samples had higher values and half the samples had lower values). (The taxpayer’s expert had not calculated whether this produced a different result than use of the mean, and the Tax Court concluded that the IRS’s expert’s approach to dealing with outliers was “more thoughtful.”) The IRS’s expert made its determination after calculating both the mean

and interquartile mean (i.e., the mean of the 50 percent of the data points falling between the 25th and 75th percentiles).

The taxpayer's expert applied adjustments for some qualitative factors, including lack of diversification and professional management. The Tax Court rejected any such discounts in this particular situation because the lack of diversification negates any need for professional management. No adjustment to the lack of control discount is needed for lack of diversification because the partnership was "transparently, the vehicle for holding shares of stock of a single, well-known corporation."

The Tax Court settled on lack of control discounts that were closer to the discounts suggested by the IRS's expert. The lack of control discounts for 1999, 2000, and 2001 were 11.32%, 14.34%, and 4.63%, respectively.

The taxpayer did not object to the lack of control discount finding on appeal, and it was not addressed by the 8th Circuit opinion.

- b. Lack of Marketability Discount Determination by Tax Court. The Tax Court acknowledged that the value being determined was "more pertinently, assignee interests in the partnership," and that a discount for lack of marketability should be applied after applying the lack of control discount. Both experts looked to studies of discounts in private placement transactions of restricted stock. The court noted that "[t]hey disagreed principally on the likelihood of a private market among the partners for LP units."

The taxpayer's expert believed that the discounts in private placement transactions of restricted shares are the starting point for determining the lack of marketability discount, but that further adjustments should be made because there is virtually no ready market. The taxpayer's expert increased the discount from median and mean discounts of 24.8 and 27.4% from the restricted stock studies to 35%. The Tax Court did not accept that he had any quantitative basis for the amount of the adjustment, and that the adjustment to 35% was just a guess.

The Tax Court adopted the approach of the IRS's expert, who looked initially to the difference in private placement discounts in restricted studies for two periods. (i) For the period before 1990 (when there was a two year holding period under Rule 144 for restricted stock and before institutional investors were allowed to buy and sell restricted stock), the average discount was 34%. (ii) For the period from 1990 to 1997 (when institutional investors were allowed to buy and sell restricted stock, but before the holding period was reduced to one year in 1997), the average discount was 22%. The difference of 12% "would appear to reflect the discount investors required for having virtually no secondary market." The appraiser considered whether the discount should be increased to reflect ongoing long-term marketability concerns with LP interests vs. the two-year only restriction that applies in the two relevant periods of the restricted stock studies. The Tax Court agreed with the IRS's expert that no significant adjustment should be made for that factor because the partners can agree to dissolve the partnership at any time and there would be an economic interest to both a limited partner wanting to exit the partnership and the remaining partners "to strike a deal at some price between the discounted value of the units and the dollar value of the units' proportional share of the partnership's NAV." The Tax Court observed that the provision in the agreement allowing consensual dissolution indicates that the preservation of family assets is not an unyielding purpose in this fact situation. The Tax Court adopted the 12.5% lack of marketability discount suggested by the IRS's expert for the 1999, 2000, and 2001 gifts.

The overall seriatim lack of control and lack of marketability discounts reported by the taxpayer on the gift tax returns was 42.5%, and the IRS gift tax audit report allowed a 28% discount. The Tax Court ended up with overall discounts of 22.4%, 25% and 16.5% in 1999, 2000, and 2001, respectively. (In this case, much larger gifts were made in 1999, and the determination of the discount in that year was particularly significant.)

c. Marketability Discount Discussion in Majority and Dissenting Opinions.

- (1) Clear Error Standard of Review. The majority viewed the marketability discount as an issue of fact subject to a clear error review standard. The dissent disagreed, stating that while the mathematical computation of fair market value is an issue of fact, the “determination of the appropriate valuation method is an issue of law” that should be reviewed de novo.
- (2) Hypothetical Willing Buyer/Willing Seller Standard Not Violated. The Tax Court adopted the IRS’s appraiser’s opinion that a “thin” market did not justify a substantial marketability discount because the partner who wished to assign his or her interests could convince the remaining partners to “strike a deal at some price between the discounted value of the units and the dollar value of the units’ proportional share of the partnership’s [net asset value].”

The taxpayers on appeal argued that putting a cap on the marketability discount because of a belief that the remaining partners would agree to pay a price somewhere between pro rata net asset value and the discounted price that a third party would pay violates the “hypothetical willing buyer/willing seller” valuation standard. The taxpayer’s brief cites various cases emphasizing that courts cannot use the price that a strategic buyer would pay, but must consider what a hypothetical willing buyer would pay. The brief cited two Tax Court cases. Estate of Jung v. Comm’r, 101 T.C. 412, 437-438 (1993) (assumption that closely held entity will redeem interests to maintain family harmony violates hypothetical willing buyer/willing seller test); Estate of Andrews v. Comm’r, 79 T.C. 938, 956 (1982) (Commissioner cannot “tailor ‘hypothetical’ so that the willing seller and willing buyer were seen as the particular persons who would most likely undertake the transaction”). The taxpayer’s brief also cited court of appeals cases from the 5th and 9th Circuits. Estate of Jameson v. Comm’r, 267 F.3d 366 (5th Cir. 2001) (reversing Tax Court because “the court should not have assumed the existence of a strategic buyer... Fair market value analysis depends instead on a hypothetical rather than an actual buyer”); Morrissey v. Comm’r, 243 F.3d 1145 (9th Cir. 2001) (“[t]he law is clear that assuming that a family-owned corporation will redeem stock to keep ownership in the family violates the rule that the willing buyer and willing seller cannot be made particular”); Estate of Simplot v. Comm’r, 249 F.3d 1191, 1195 (9th Cir. 2001) (Tax Court assumed buyer “would probably be well-financed, with a long-term investment horizon and no expectations of near-term benefits;” reversed, holding that “[t]he facts supplied by the Tax Court were imaginary scenarios as to who a purchaser might be... [A]ll of these imagined facts are what the Tax Court based its 3% premium upon. In violation of the law the Tax Court constructed particular possible purchasers”).

These cases all have strong language saying not to assume particular purchasers, and in particular, not to assume that the entity will redeem interests of a prospective seller of an interest in the entity. Despite that well developed body of case law, the 8th Circuit majority opinion in Holman agreed with the Tax Court:

“When assessing hypothetical transactions between hypothetical buyers and sellers, it is improper to ascribe motivations that are personal and reflective of the idiosyncrasies of particular individuals. [Citations omitted.] Rather it is necessary to view such persons as economically rational actors possessing all relevant information and seeking to maximize their gains. [Citations omitted.]

Here we believe the Tax Court’s approach in adopting Mr. Burns’s analysis comports with this general rule of casting the potential buyer merely as a rational economic actor. A buyer possessed of all relevant information would know that (1) the underlying assets are highly liquid and easily priced; (2) the amount held by the partnership could be absorbed by the broader market...; (3) the partnership agreement permits the buying out of exiting partners or dissolution upon unanimous consent of all partners; and (4) there would be little or no economic risk and likely no additional capital infusion necessary for remaining partners to buy out an exiting partner.

Against this backdrop, it is not necessary to look at the personal proclivities of any particular partner or the idiosyncratic tendencies that might drive such a specific person’s decisions. Rather it is only necessary to examine what is technically permissible in accordance with the agreement and forecast what rational actors would do in the face of a pending sale at a steep discount relative to net asset value. Simply put, the Tax Court did not ascribe personal non-economic strategies or motivations to hypothetical buyers; it merely held that, presented with the opportunity, rational actors would not leave money on the table.”

The dissent believed that a critical element of the analysis was ignored by the majority:

“That is not to say that courts err whenever they consider partnership agreements’ dissolution provisions while calculating an appropriate marketability discount. For example, if the Holman limited partnership had a significant history of dissolving and buying out wishing-to-assign partners, a hypothetical willing buyer would consider this fact while assessing the partnership interests’ marketability...”

Here, the Commissioner’s expert never determined the actual likelihood of the Holman limited partnership executing a dissolution and buy-out scheme. Holman, 130 T.C. at 214. The expert merely opined that he could not ‘envision an economic reason why’ the partnership would not engage in such a scheme...This analysis is not helpful because it does not consider the fact that the Holman limited partnership has never engaged in such a scheme...or whether the Holman limited partnership or limited partnership owners do or do not have sufficient liquidity to buy out a wishing-to-assign partner... Against this factual backdrop, the hypothetical willing buyer may find that the actual probability of the remaining partners unanimously consenting to a dissolution and buy-out scheme is quite low.”

The dissent concluded that the misapplication of the willing buyer/willing seller test was reversible error and the case should be remanded to the Tax Court for a new determination of the marketability discount.

- d. Approach of Comparing Results of Private Placement Studies for Rule 144 Stock During Periods When Institutional Investors Were and Were Not Allowed to Buy Stock. The Tax Court adopted the approach of the IRS's expert, who looked initially to the difference in private placement discounts in restricted studies for two periods. (i) For the period before 1990 (when there was a two year holding period under Rule 144 for restricted stock and *before institutional investors were allowed to buy and sell restricted stock*), the average discount was 34%. (ii) For the period from 1990 to 1997 (*when institutional investors were allowed to buy and sell restricted stock*, but before the holding period was reduced to one year in 1997), the average discount was 22%. The IRS expert believed the difference of 12% "would appear to reflect the discount investors required for having virtually no secondary market." The Tax Court does not address why it is the *difference* between these two periods that is so magical, resulting in a 12.5% discount. (Why is the 22% or even the 34% figure not the relevant amount for estimating the marketability discount, particularly in light of the fact that the marketability concerns for FLP interests are long-term rather than just for two-years as in the Rule 144 private placement studies?)

As discussed below, other appraisers have criticized the approach of basing the marketability discount on the *difference* in private placement discount amounts during these two particular periods (one calls it a "cockamamie methodology").

Observations From Holman:

1. Continued Trend of Allowing Significant Discounts for Marketable Securities FLPs. Even though the taxpayer lost both of the issues in this appeal, the overall discount for this FLP, which held only one publicly traded stock, was significant. In 1999, the year in which most of the gifts were made, the court allowed an overall discount of 22.4%. (The discounts allowed for 2000 and 2001 were 25% and 16.5%, respectively; the discount being much lower in 2001 because of the very low lack of control discount reflected in studies of closed-end funds for 2001. The court's analysis suggests that obtaining close to 50% discounts for marketable securities FLPs (particularly one that holds only one stock) is not realistic; but this case continues the almost uniform trend of allowing significant discounts for marketable securities FLPs. (The case obviously does not include a §2036 issue, because this is a gift tax case, and that is the issue that has generated the most success for the IRS.)

The §2703 ruling, providing that transfer restrictions in the agreement were to be disregarded in value the partnership interests, does NOT mean that discounts are not available for investment partnerships—only that no additional restrictions attributable to specific transfer restrictions in the agreement more restrictive than state law restrictions, were to be disregarded.

2. Bona Fide Business Arrangement Test Under §2703 May Be Hard to Meet For Transfer Restrictions in Many FLPs. For many years, cases involving the effectiveness of the price set in buy-sell agreements have considered a similar bona fide business arrangement test, and have almost uniformly found that planning for continuity of ownership satisfies the bona fide business arrangement test. In Estate of Amlie, the IRS argued that the settlement agreement regarding the purchase of the ward's bank stock at the ward's death could not meet the bona fide business arrangement test because the bank stock "was not an actively managed business interest but merely an investment asset." The Amlie court rejected that argument, and found that hedging the

risk of a fiduciary's holdings and planning for future liquidity needs constitute sufficient "business purposes" for purposes of this test. The majority opinion of Holman, however, concluded that those conditions did not exist for the Holman situation.

The effect of Holman is that providing for continuity of ownership or control of who becomes a successor partner is *not* necessarily a sufficient business purpose for this test where there is not a closely held business. We do not know precisely what the test is if there is not an operating business, but a stricter test is applied. The particular facts identified by the majority opinion that caused preserving family control in this investment partnership not to meet the bona fide business arrangement requirement are (i) the partnership holds an insignificant fraction of stock in a highly liquid and easily valued company (ii) with no stated intention to retain that stock of invest according to any particular strategy. The court says that the purposes of "disincentivizing" children from getting rid of specific partnership assets, of spending the wealth represented by partnership assets, or feeling entitled to partnership assets, or educating children about family wealth are not sufficient purposes for this test, at least where there is not an operating business. (This is reminiscent of the position in several cases [before Mirowski] that factors related to facilitating gifts are not sufficient "legitimate and significant non-tax reasons" to apply the bona fide sale exception to §2036. Several cases now suggest that facilitating transfers and facilitating administration after gifts are made *is* a legitimate non-tax reason for purposes of the §2036 exception [i.e., Mirowski, Keller, and Shurtz].)

The dissent would recognize the following as bona fide business arrangements: "(1) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnership's investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preserving the partners' fundamental right to choose who may become a partner."

As a practical matter, those *are* the purposes served by having transfer restrictions in an investment FLP that is being owned by or transferred to younger family members. The court's reasoning raises a huge question as to whether transfer restrictions can be considered in valuing shares in many (if not most) FLPs that do not involve actively managed businesses. (However, as discussed in Item 10 below, there may be very little valuation impact by ignoring transfer restrictions in the agreement for valuation purposes in some situations.)

3. Retreat From Strict Application of Hypothetical Willing Buyer/Willing Seller Standard. There seems to have been a trend in the cases toward strict application of the *hypothetical* willing buyer/willing seller valuation standard. See the Jameson, Morrissey, and Simplot 5th and 9th Circuit cases cited above. The majority opinion analysis seems to say that the remaining partners would be rational economic actors to purchase the interest of any partner that wanted to transfer its interest and to purchase the interest at some price above what a third party (i.e., a hypothetical third party) would be willing to pay. If this analysis is supported by future cases, it would dramatically reduce marketability discounts. All of the partners of a partnership and all of the shareholders of a corporation can at any time unanimously agree to changes to the entity, including the ability to dissolve the entity. The court's analysis would seem to apply to all entities and particularly all partnerships. As opposed to the discounted value that a third party would be willing to pay, courts could assume that the remaining owners would always place a floor on the discount because if the price were discounted too much, they would strike a deal with the exiting partner or shareholder at a compromise price. That sure sounds like a strategic buyer approach, and seems like a significant retreat from the trend of cases strictly applying a *hypothetical* willing buyer/willing seller standard.

The taxpayer's brief pointed out that this approach may dramatically reduce the marketability discount compared to what hypothetical third party buyers are actually willing to pay for the interest:

“As in *Morrissey*, *Simplot*, and *Jameson*, the Tax Court's fair market value analysis violated the hypothetical willing buyer/willing seller standard. The Tax Court reversibly erred when it adopted Mr. Burns's assumption that the fair market value of the Transferred Interests should be determined by reference to the speculative possibility that an owner of an interest in the Partnership would assume that the partners would, rather than face paying fair market value with its inherent 'significant' (in the Tax Court's word) discount for lack of marketability and lack of control, instead dissolve the Partnership and reconstitute the entity.... The Tax Court's error caused it to determine a 12.5% lack of marketability discount, **which even the Tax Court recognized was lower than the 'significant' discount that would otherwise be applied.**” (boldface emphasis added)

If this approach is followed by other courts, it may dramatically reduce marketability discounts. We might expect that IRS agents will frequently cite this case to support low marketability discounts.

4. IRS's Expert's Rule 144 Analysis. As discussed in Item 3.d of the Analysis section above, the approach of taking the difference between discounts in private placements of Rule 144 restricted stock between two different periods seems to have no basis. The Tax Court did not explain why that difference made sense as the appropriate marketability discount. Lance S. Hall, Managing Director of FMV Opinions, Inc., has observed that neither the majority nor dissenting opinion addresses “the cockamamie methodology, widely criticized in the valuation community.” He concludes that analysis “defies all logic.” Lance S. Hall, Eighth Circuit Upholds IRS §2703 Victory Regarding a Marketable Securities FLP, FMV Valuation Alert (April 8, 2010).

The taxpayer's brief points out that there is a fundamental flaw in this analysis. The partnership interests in the Holman partnership will likely never be registered under federal and state securities laws, so they can never be sold in the public market or marketed to the public. This situation will continue indefinitely, not just for the two-year holding period reflected in the private placement studies for Rule 144 stock. The brief highlights the flaw in the analysis:

“Thus, the interests in the Partnership – which both experts acknowledged will likely never be registered – are effectively subject to an unlimited ‘holding period,’ as that holding period concept is used in the restricted stock studies.... Although the prohibition against trading restricted shares in the public market will expire at the end of the relevant holding period, **interests in the Partnership can never be sold in the public market or marketed to the public without registration under the federal and state securities' laws.** Mr. Burns (the IRS's expert) correctly acknowledged that the so-called private ‘market’ in which a holder of Rule 144 restricted stock could sell the stock was very ‘thin,’ and that this ‘thin private market’ for Rule 144 restricted stock was ‘similar to what we have with the limited partnership,’.... The same thin private market in which Mr. Burns acknowledged the Partnership interest could be sold reflects private sale transactions in restricted stock with only a two-year holding period occurring at an average lack of marketability discount of 34%. See also David Laro & Shannon P. Pratt, *Business Valuation and Taxes – Procedure, Law and Perspective* 290-291 (2005). The observed discount is virtually identical to Mr. Ingham's [the taxpayer's expert] 35% conclusion.”

5. “Bad Law” From “Gut Reaction” to Overall Discount? The issues discussed in Items 3-4 above both reflect that the analysis by the Tax Court seems to run counter to established valuation

methodology. The 8th Circuit affirmed the reasoning, under the majority's belief that "it is appropriate to defer to the reasoned judgment and fact-finding ability of the Tax Court." One wonders if, as in perhaps most valuation cases, the Tax Court judges had a "gut reaction" to the valuation issue and that a 35% marketability discount together with the 11.32%, 14.34% and 4.63% lack of control discounts (for the three relevant years), which would result in seriatim discounts of 42.4%, 44.3% and 38.0%, respectively, was just "too much" for a partnership that held one publicly traded stock. In searching for a rationale to justify a lower overall discount, based on the trial testimony that it had to work with, perhaps the court ended up approving methodologies and approaches that seem to be "out of the mainstream."

6. Impact on §2036 Bona Fide Sale Exception Issue. The analysis seems to hint that the two judges in the majority would apply a strict approach to considering whether the bona fide sale exception to §2036 will apply. In distinguishing the Schutt case, the majority observes: "Here, then, unlike Schutt, the family membership, educational, and tax-reduction purposes overshadow any claim of a business purpose for the restrictions."
7. Device Test Analysis Seems Misguided; If the Court is Correct, Many Transfer Restrictions and Buy-Sell Agreements Will Not Be Respected Under §2703 Even For Actively Managed Businesses. The court reasons that transfer restrictions prevent an LP from realizing full value of a proportional part of the FLP's assets. Furthermore, the entity's ability to acquire any interest that is purportedly transferred in contravention of the agreement based on the fair market value of the interest (presumably with discounts) means that the value of the remaining partners' interests will increase in value. Critical to this analysis is that the parents (who are the donors of the gifts) are the ones who can decide on behalf of the partnership to exercise the purchase option, and thereby redistribute value to the other owners for less than full consideration.

An example may help. Assume that an FLP has a NAV of \$1,000. Assume that the parents own 10 units of ownership and that three children each own 30 units of ownership. Assuming a 25% discount for the units, each child's value would be $1,000 \times 30\% \times 75\%$ [reflecting a 25% discount], or \$225. If one child attempts to transfer his units without getting consent, (and if the transfer is deemed to be effective despite the prohibition in the agreement), the partnership could purchase those units, at their discounted value of \$225. The partnership would then have a $\$1,000 - 225$, or \$775 NAV. After the redemption, there would be 70 ownership units outstanding, and each remaining child would own 30/70, or 42.86% of the partnership units. Each remaining child's units would be valued at $\$775 \times 42.86\% \times 75\%$, or 249.11. Thus, the court's conclusion is right in that an exercise of the repurchase option would increase not only each remaining child's proportionate share of the partnership's NAV but also each remaining child's fair market value of the LP units themselves.

The purchase option under §9.3 of the Holman partnership agreement was somewhat unusual in allowing the partnership to purchase the transferred shares at a value based on their right to share in distributions. That provision may result in a lower value than a mere purchase option at "fair market value." However, the court's analysis of the device test did not refer at all to the special valuation provision in §9.3, but just referred to the ability of the partnership to purchase the units at less than their proportionate share of the net asset value of the partnership (which would apply to most transfer restrictions that give the entity the right to purchase transferred shares at their fair market value [i.e., considering appropriate discounts]).

If the Holman Tax Court's approach is correct, many buy-sell agreements, even for active businesses (if the fair market values of individually held interests in the business are less than pro rata net value of the entire entity), would not be respected under the §2703 safe harbor. If the parents hold offices in the entity or

own sufficient ownership to control (or perhaps even to impact) the decision to exercise any available purchase option that arises upon a purported transfer that is not permitted under the agreement, the parent could redistribute value for less than full and adequate consideration, which in the court's opinion would flunk the device test. That would be a huge surprise to planners of buy-sell agreements, and it is a totally novel approach to viewing the long-held requirement applied by case law of requiring that the agreement is not a device to transfer value to natural objects of the decedent's bounty for less than full consideration. (That test has historically been applied by looking primarily to the fairness of the purchase price or formula for determining the purchase price that is set in the agreement.)

It is most unfortunate that the 8th Circuit did not choose to revise this misguided analysis (and neither the majority nor dissenting opinions addressed this flawed reasoning). It is not as if they were not aware of the dire implications of this reasoning on buy-sell agreements commonly used for most businesses and legal entities. The taxpayer's brief pointed out the dramatic implications of this reasoning:

“Notwithstanding the fact that the partnership experts for both the Holmans and the Commissioner acknowledged that paragraphs 9.1 through 9.3 are common provisions entered into by parties in arm's-length transactions, the Tax Court held the so-called ‘redistributive effect’ of such a transaction causes the transfer restrictions and right of first refusal to be a device...No other court (including the Tax Court) has ever applied the device test analysis in this manner. The reason is simple. The Tax Court's flawed analysis would cause any buy-sell agreement or right of first refusal in an entity with a fair market value purchase price to violate the device test.”

If the only restriction in an agreement is a provision that allows the entity to purchase transferred shares at their fair market value, the agreement may have little impact on valuation. In that case, the court's reasoning could lead to the anomalous result that the §2703(b) safe harbor would not apply [because of failing the device test] even though the agreement had little if any effect on value, so that there would be little valuation difference even if §2703(a) applied.

The Tax Court's reasoning (i.e., that the parents have the power to redistribute wealth among their children for no consideration in the event of an impermissible transfer) raises the specter of whether these types of very common transfer restrictions with purchase options for impermissible transfers might give the IRS an additional argument to cause §2036(a)(2) or 2038 to apply if parents are the general partners (and therefore can control or impact the decision of whether the partnership will exercise its purchase option).

8. Reasonable Approach to Evidence Required to Satisfy Comparability Test Under §2703. Almost all cases that have addressed the §2703(b) safe harbors have ended up having an extended discussion of the comparability test with little discussion of the bona fide business arrangement or device test. The Tax Court case is the opposite.

The case is a welcome development with respect to the evidentiary standards for satisfying the comparability test, by reflecting a reasonable approach of evaluating opinions of experts as to whether certain types of transfer restrictions (or presumably other provisions in buy-sell agreements) are comparable to provisions in agreements among unrelated parties *generally*, without requiring expert testimony of specific examples of other agreements. This is a welcome change from the approach of several other cases that have addressed the comparability requirement. The majority and dissenting opinions in the 8th Circuit cases do not address this evidentiary issue.

In Estate of Blount v. Comm’r, T.C. Memo. 2004-116, aff’d in part, rev’d in part, 428 F.3d 1338 (11th Cir. 2005), the court applied the comparability test very strictly. To meet the comparability test, the court wanted to see (1) buy-sell agreements actually negotiated in arm’s length situations under similar circumstances and in similar business, and (2) that are comparable (as to term of agreement, present value of property, expected value at time of exercise, and consideration offered for the option) to the terms of the agreement being tested. The Tax Court found that the estate’s expert testimony was not sufficient. The expert said that a four times earnings multiple is typically used to value construction companies in three purportedly comparable companies he examined. The court said the companies were not really comparable. Furthermore, the court noted that the expert did not base his opinion on actual agreements involving comparable companies: “He did not present evidence of other buy-sell agreements or similar arrangements, where a partner or shareholder is bought out by his coventurers, *actually entered into* by persons at arm’s length...Because Mr. Grizzle has failed to provide any evidence of *similar arrangements actually entered into* by parties at arm’s length, as required by section 2703(b)(3) , and his opinion is based solely on his belief that the purchase price for decedent’s BBC shares was set at fair market value, Mr. Grizzle’s conclusion that the terms of the Modified 1981 Agreement are comparable to similar agreements entered into by parties at arm’s length is unsupported.” (emphasis added) Finding comparable buy-sell agreements (which are inherently very private documents) could be very difficult. Furthermore, the court wants evidence that the terms are similar to agreements in the general practice of unrelated parties, and not just isolated comparables. This would seem to be a very difficult evidence burden that the court is imposing. The court found that the comparability test was not met in this situation, where the agreement provided a set price of \$4 million compared to a book value (which was the formula price under a prior agreement) of \$7.5 million. The price would not be adjusted over time by a formula. The Eleventh Circuit found no error with the lower’s analysis of the comparability factor.

Another court similarly refused to accept affidavits of attorneys that the court viewed as being merely conclusory in nature. Smith v. Commissioner, 94 AFTR 2d 5283 (W.D. Pa. 2004). The court suggested a high standard of proof to satisfy the comparability test:

“In this case, both parties concede that it would be inherently difficult to find an agreement between unrelated parties dealing at arms' length that would be comparable to a family limited partnership, which, by its terms, is restricted to related parties.... Nevertheless, Plaintiffs have submitted the affidavits of two attorneys...who essentially state that restrictive provisions requiring installment payments and charging interest at the applicable federal rate are common in both family limited partnerships and transactions involving unrelated parties.... Upon review, these affidavits merely state opinions that are conclusory in nature and do not constitute evidence sufficient to dispel any genuine issue of material fact as to whether of the restrictive provision in the Smith FLP agreement meet the test set forth in Section 2703(b)(3).”

9. Comparability Test; Novel Theory. The Tax Court did not address the novel theory of the IRS that the transfer restrictions did not meet the comparability test because no arm’s length third person would enter the arrangement at all (to tie up an investment for 50 years in a partnership holding one publicly traded stock presenting nothing particularly special to justify such a restrictive investment). The IRS expert testified that the specific transfer restrictions themselves were very commonly used in arm’s length arrangements but “that was beside the point.” The IRS argued that there an “overall circumstances” test that should be applied, rather than just looking to whether particular restrictions themselves are commonly used. The Tax Court declined to address that novel theory. The 8th Circuit opinion did not address it directly either, but footnote 5

in the majority opinion suggests that the majority was at least intrigued by the issue and because of that did not agree with the dissent that the agreement of the experts that similar transfer restrictions are commonly used would satisfy the comparability test. The “overall circumstances” argument is likely to re-appear in future cases.

10. Impact on Value of Refusing to Recognize FLP Transfer Restrictions Under §2703. The court held that *transfer restrictions in the agreement* could not be considered in valuing the gifts of LP units, because of §2703. The transfer restrictions in the agreement added several elements that are not present under state law. The agreement purported to prohibit transfers absolutely without consent of the other partners, rather than just requiring consent of the partners to recognize a successor owner as a full partner rather than just as an “assignee.” Also, the agreement added that the partnership could elect to purchase at fair market value (i.e., the discounted value) an interest that is impermissibly transferred, and allowed making the purchase with a 5-year note having an AFR interest rate.

The court obviously did allow appraisers to consider the other restrictions on the rights of limited partners under general state law principles, in light of the fact that the court found that significant lack of control and lack of marketability discounts applied. The opinion nowhere suggested what kind of value adjustment would be attributable to the prohibition on transfers under paragraph 9.1 of the agreement. However, as to the repurchase option under paragraph 9.3, the taxpayer’s expert believed that considering the paragraph 9.3 provision would reduce the value by only about 2.4%. (For example, Appendix B of the Tax Court opinion reflects that, for the big gift made in 1999, the value would be \$1,096,360 if paragraph 9.3 is considered and \$1,123,769 if it is not considered. The percentage difference is 27,409/1,123,769, or 2.4%) The appendices indicate that the IRS’s expert would have valued the shares about 15% lower taking into account the special valuation provision in §9.3. The taxpayer’s brief stated that “Mr. Burns concluded that the Partnership’s right to pay for an interest over time transferred in contravention of the Partnership Agreement had an even greater valuation impact than the lack of marketability resulting from the legal and practical constraints on selling an interest in the Partnership in what Mr. Burns acknowledged was a ‘thin’ market.”

Of course, a determination that the price set in a buy-sell agreement would not be respected under §2703 can have a huge impact on value. But just ignoring specific transfer restrictions in a limited partnership agreement may have limited significance in some situations.

11. Determine Marketability Discounts Based on Limited Market for “Assignee” Interests. Several prior cases have had an extended discussion of whether to value transferred interests as mere assignee interests or as full limited partnership interests. Astleford, Estate of Dailey, Kerr, and Estate of Jones all valued the transfers as limited partnership interests, and Estate of Nowell valued the transferred interest as an assignee interest. The court did not address this issue, but interestingly the Tax Court made the following observation at the beginning of its discussion of the marketability discount:

“The parties agree that, to reflect the lack of a ready market for LP units (*or, more pertinently, assignee interests in the partnership*)... an additional discount... should be applied ...” (emphasis added).

If the marketability discount is determined based on the value of an assignee interest in any event, it would seem to make little valuation difference whether the transferred interest is viewed as a partnership interest or as an assignee interest.

Synopsis of Fisher II:

“Fisher I” held that gifts of LLC member interests did not qualify for the annual exclusion. 105 AFTR 2d 2010-1347 (S.D. Ind. March 11, 2010). A subsequent case dealt with cross motions for partial summary judgment as to whether “transfer restrictions imposed upon the gifts made by the Fishers to their children should be considered in determining the value of those gifts” under §2703. Fisher v. U.S., 106 AFTR 2d 2010-6144 (S.D. Indiana Sept. 1, 2010). Under the LLC’s Operating Agreement, the Fisher children could transfer their interests they received by gifts from their parents only if the LLC chooses not to exercise a right of first refusal to purchase the interest at a price equal to the amount of the prospective transferee’s offer with non-negotiable promissory notes that are payable over a period of time not to exceed fifteen years “in equal annual installments of principal and interest, the first of which shall be due and payable one (1) year after the Closing Date.” Relying primarily on the Holman case, the court concluded that there was no evidence that met the bona fide business arrangement requirement in §2703(b) and granted the government’s motion for partial summary judgment. The LLC held primarily a parcel of undeveloped land, a portion of which eventually was sold by the LLC. Apparently, the taxpayers tried to argue that there were facts suggesting that holding the real estate was a bona fide business.

Analysis in Fisher II:

The court pointed to the Eighth Circuit’s reasoning in Holman that restrictions on the children’s transfer of their FLP interests “did not serve a bona fide business purpose because the partnership was not a “‘business,’ active or otherwise.” The court pointed to various facts suggesting the absence of a business, including that there was no investment strategy preserved by the LLC, there was no ongoing investment in the property to increase its commercial value, there was no effort to acquire or pursue acquiring additional real property. Even though a financial officer was employed to manage the expenses associated with the property, and even though the children occasionally deposited money into the LLC’s checking account to pay real estate taxes and other expenses, the court concluded that “[s]imilar facts could be found in connection with every interest in real estate. They do not, as the Fishers assert, indicate that [the LLC] was a bona fide business.”

The court did not address, at all, the argument in the Holman dissent that the legislative history to §2703 suggested that maintaining family control is a legitimate business purpose for buy-sell agreements even when the control involves just the “right to receive income from investments” or “to participate as a limited partner.” The Holman dissent said that the focus should be on the business purpose of the restriction:

“Thus, I would hold that the Holman partnership agreement restrictions are ‘bona fide business arrangements’ because they were not created for the primary purpose of avoiding taxes, and they served the following legitimate business purposes: (1) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnerships’ investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preserving the partners’ fundamental right to choose who may become a partner.”

There is no indication in the opinion that the taxpayer made those arguments; in any event, the court made absolutely no mention of that line of reasoning or why it was inappropriate.

Having decided that the first of the three requirements in the §2703(b) safe harbor was not satisfied, the court said there was “no need ... to address the remaining two requirements.”

Concluding Observations From Holman and Fisher II:

Section 2703 will likely not allow considering transfer restrictions in valuing FLP interests for most investment partnerships because of the strict test for meeting the “bona fide business arrangement” requirement of the §2703 safe harbor where there is not an operating business. The reasoning of applying the “bona fide business arrangement” test of §2703(b)(1) to investment partnerships and LLCs may be questioned because the courts looked to whether the entity is a bona fide business arrangement rather than whether the restriction itself is a bona fide business arrangement and because the legislative history to § 2703 suggested that entities in which the participant merely has the “right to receive income from investments” could meet the § 2703(b) safe harbor tests. However, three courts have now adopted the more restrictive approach announced by Judge Halpern in the Holman Tax Court case, and until a court reverses that trend, it sure appears that transfer restrictions in partnership and LLC governing documents that are more restrictive than state law will not be considered in valuing interests in those entities for transfer tax purposes.

There is still some room for arguing that certain investment entities, even under the reasoning of Holman and Fisher II may be able to satisfy the “bona fide business arrangement” safe harbor. For example, in Fisher II, the court emphasized that there were no plans for active management of the investment assets, suggesting that an entity that had a plan for active management of investment assets, rather than merely holding passive assets and collecting rent payments, might be able to satisfy the “bona fide business arrangement” requirement.

Bear in mind that the Holman and Fisher II cases do NOT mean the discounts are disallowed totally for interests in partnerships and LLCs. Indeed, in Holman, the court allowed a 22.5% discount for transfers of limited partnership interests in a partnership holding only Dell stock, where the transfers were made six days after the partnership was created. The IRS has tried to assert that §2703(a) requires disregarding the existence of the entity *totally* as a restriction on the “right to acquire or use the property.” Courts have rejected that, reasoning that the “property” being referred to in §2703(a) is the property transferred, i.e., an interest in the partnership or LLC, not the assets contributed to the entity. In Church v. United States, 85 A.F.T.R.2d 2000-804 (W.D. Tex. 2000), aff’d, 268 F.3d 1063 (5th Cir. 2001), the court concluded that § 2703(a) does not apply, because the transfer was of a partnership interest, not partnership assets, so restriction on the use of the partnership assets would not be ignored. In addition, the court found that the elements of the § 2703(b) safe harbor existed (bona fide business arrangement, not a testamentary device to transfer property to family for less than full consideration, and restrictions in the partnership agreement were comparable to similar arrangements entered into by persons in arms-length transactions). Similarly, in Estate of Strangi v. Comm’r, 115 T.C. 478 (2000), aff’d as to this issue sub nom Gulig v. Comm’r, 293 F.3d 279 (5th Cir. June 17, 2002), the IRS tried to apply § 2703 by treating the partnership assets as the transfer to be tested under § 2703, so that restrictions on the use of the assets because they were in the partnership should be ignored for estate tax purposes. The court rejected the IRS’s § 2703 argument, and stated that the partnership interest (not the partnership assets) were transferred, so restrictions on the use of the partnership assets are irrelevant, and § 2703(a) does not apply. The court did not have to address the applicability of § 2703(b) safe harbors.

Appraisers typically do not attribute much additional discount to specific transfer restrictions in the agreement compared to restrictions inherent under state law with respect to interests in the entity. The government’s appraiser in Holman would have attributed a 15% discount to the right of first refusal provision giving the entity the right to acquire transferred interests for a ten-year note, but the taxpayer’s appraiser in that case said that the transfer restriction added only an additional 2.4% discount, and this seems to be the general approach of most appraisers.

In any event, there are indications that IRS agents are raising § 2703 issues frequently in gift tax cases involving transfers of interests in entities.

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