

## Catholic University Law Review

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Volume 59  
Issue 1 Fall 2009

Article 9

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2009

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#### Recommended Citation

Alden Koste, *The IRS Fished Its Wish: The Ability of Section 2703 to Minimize Valuation Discounts Afforded to Family Limited Partnership Interests in Holman v. Commissioner*, 59 Cath. U. L. Rev. 289 (2010).

Available at: <https://scholarship.law.edu/lawreview/vol59/iss1/9>

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## NOTE

### THE IRS FISHED ITS WISH: THE ABILITY OF SECTION 2703 TO MINIMIZE VALUATION DISCOUNTS AFFORDED TO FAMILY LIMITED PARTNERSHIP INTERESTS IN *HOLMAN V. COMMISSIONER*

*Alden Koste*<sup>+</sup>

Twenty-six million: the dollar amount that decedent *A* saved in estate taxes by transferring assets into a limited partnership structure.<sup>1</sup> Fifty-two million: the dollar amount by which decedent *B*'s estate tax increased after the Internal Revenue Service (IRS) successfully used section 2036(a) of the Internal Revenue Code (IRC) to recapture the partnership's interests back into the decedent's gross estate.<sup>2</sup>

Family limited partnerships (FLP) have become an integral estate planning tool because they provide both generous tax advantages and organizational structure to one's transferred property.<sup>3</sup> In *Holman v. Commissioner*, husband and wife petitioners established an FLP—the Holman Limited Partnership—with the intention of safeguarding the family's assets while simultaneously educating their four children on wealth management.<sup>4</sup> Petitioners then transferred a substantial amount of Dell stock to their newly created FLP and proceeded to make large gifts of limited partnership interests in 1999 and subsequent smaller gifts in 2000 and 2001.<sup>5</sup> When valuing those gifts for federal gift tax purposes, the lack of marketability and the minority interest

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1. See *Estate of Harrison v. Comm'r*, 56 T.C.M. (P-H) 40, 41 n.3 (1987) (noting that the decedent "increased the value of the limited partnership interest" by \$26,555,020).

2. See *Estate of Bongard v. Comm'r*, 124 T.C. 95, 96, 131 (2005) (finding that the decedent had an "estate tax deficiency" of \$52,878,785); *infra* Part I.C.3 (exploring retained interests in IRC section 2036); see also Walter D. Schwidetzky, *Family Limited Partnerships: The Beat Goes On*, 60 TAX LAW. 277, 303 (2007) (discussing the *Bongard* decision).

3. See, e.g., Andrea B. Short, Comment, "Adequate and Full" Uncertainty: Courts' Application of Section 2036(a)(1) of the Internal Revenue Code to Family Limited Partnerships, 84 N.C. L. REV. 694, 697 (2006) (describing the popularity of FLPs as an estate planning mechanism).

4. *Holman v. Comm'r*, 130 T.C. 170, 172–76 (2008).

5. *Id.* at 183.

status were asserted as bases for tax discounts.<sup>6</sup> The IRS challenged the petitioners' discount calculations, arguing that, for valuation purposes, section 2703 of the IRC disallowed restrictions contained in the partnership agreement.<sup>7</sup>

This Note addresses the IRS's attempt to minimize valuation discounts for limited partnership interests in FLPs. First, this Note examines the origins of FLPs and evaluates the potential benefits of using FLPs as estate planning mechanisms. Second, this Note explores the IRS's prior attempts to minimize the valuation discounts afforded to limited partnership interests. Third, this Note delves into the *Holman* case and considers how the IRS successfully employed section 2703(a). Lastly, this Note predicts the future implications that the *Holman* decision may have on valuation discounts in FLPs and suggests that the decision may not be as detrimental to taxpayers as predicted.

## I. FAMILY LIMITED PARTNERSHIPS EXAMINED

### A. Burden of Taxes on Estates and Gifts

FLPs are estate planning mechanisms that allow an individual to avoid taxes by transferring assets into an alternate instrument.<sup>8</sup> The limited partnership structure allows taxpayers to actualize estate planning objectives because they "preserve the estate and facilitate transfer of wealth from one generation to the next with the least possible transfer cost."<sup>9</sup> Taxpayers are attracted to FLPs because the mechanism allows for substantial valuation discounts resulting from minority interest status and a lack of marketability—concepts derived from the inherent restrictions placed on property that is transferred to the partnership.<sup>10</sup>

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6. *Id.*

7. *Id.* at 183–84.

8. See Rebecca B. Hawblitzel, Note, *A Change in Planning: Estate of Strangi v. Commissioner's Effect on the Use of Family Limited Partnerships in Estate Planning*, 57 ARK. L. REV. 595, 602 (2004) (explaining that transferring individual assets "into a separate entity" is an effective strategy to prevent estate taxes). Although the FLP structure was historically used for income tax planning, it has more recently been utilized as an attractive gift and estate planning device. Kenneth P. Brier & Joseph B. Darby, III, *Family Limited Partnerships: Decanting Family Investment Assets Into New Bottles*, 49 TAX LAW. 127, 127 (1995) (citing "a series of successful estate tax valuation cases" and "formal concessions by the Service" to explain the increased attraction of FLPs in estate planning).

9. Jonathan C. Lurie & Edwin G. Shuck, Jr., *Valuation*, in AM. LAW INST.-AM. BAR ASSOC., ESTATE PLANNING IN DEPTH 231, 235 (2008).

10. Brant J. Hellwig, *Revisiting Byrum*, 23 VA. TAX REV. 275, 277–79 (2003) (recognizing that "valuation discounts are the driving force behind the widespread use of limited partnerships to transmit wealth"). In addition to the tax benefits afforded under FLPs, there are a number of non-tax advantages that can be enjoyed by the taxpayer: control of the entity within the family, creditor protection, probate avoidance, avoidance of intra-family litigation, and greater management flexibility than would be afforded under a trust arrangement. Stefan F. Tucker, *The*

FLP structures may help curtail both estate taxes and gift taxes. Section 2001(a) of the IRC imposes a federal tax “on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.”<sup>11</sup> Additionally, IRC section 2501(a)(1) imposes a yearly tax “on the transfer of property by gift” from any taxpayer.<sup>12</sup> In an attempt to circumvent these tax burdens, taxpayers transfer assets into limited partnerships that allow for substantial discounts.

Initially, FLPs successfully realized their purported tax advantages.<sup>13</sup> However, in an effort to minimize taxpayer abuse of the FLP structure, the IRS mounted an effort in the 1990s to attack these arrangements more aggressively.<sup>14</sup> Although the abuse concerns were warranted, the IRS lacked methodological consistency when addressing suspected taxpayer misuse of FLPs. For example, in *Peracchio v. Commissioner*, the IRS filed a notice of deficiency—based on four separate rationales—alleging that the taxpayer underestimated gift taxes due for transfers under an FLP structure.<sup>15</sup> Once the

*Continuing Battle Over FLPs and FLLCs*, in AM. LAW INST.-AM. BAR. ASSOC., MODERN REAL ESTATE TRANSACTIONS 1, 7–12 (2008).

11. I.R.C. § 2001(a) (2006).

12. I.R.C. § 2501(a)(1). The gift is valued at the date of the transfer. I.R.C. § 2512. It is further clarified that such a tax “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.” I.R.C. § 2511(a).

13. See *Harwood v. Comm’r*, 82 T.C. 239, 268 (1984). In *Harwood*, the court allowed a fifty percent discount in the valuation of the partnership interests in an attempt “to reflect the fact that the interests . . . being valued were minority interests, were not publicly traded, and were subject to the restrictive clause in the . . . partnership agreement.” *Id.* Similarly, in *Estate of Harrison v. Commissioner*, the government and the taxpayer submitted different figures concerning the value of the limited partnership interests. *Estate of Harrison v. Comm’r*, 56 T.C.M. (P-H) 40, 41 (1987). The government claimed the limited partnership interests should be valued at \$59.5 million, but the taxpayers contended that a \$33 million valuation was appropriate. *Id.* Ultimately, the court, recognizing that a hypothetical buyer would receive a lower price due to the inability to liquidate the partnership, applied a forty-five percent discount and valued the partnership interests at \$33 million. *Id.*; see also Brier & Darby, *supra* note 8, at 132–33.

14. INTERNAL REVENUE SERV., APPEALS COORDINATED ISSUE SETTLEMENT GUIDELINES, Discounts for Family Limited Partnerships, UIL No. 2031.01-00, at 2–3 (2006), available at [http://www.irs.gov/pub/irs-utl/asg\\_penalties\\_family\\_limited\\_pships\\_finalredacted10\\_20\\_06.pdf](http://www.irs.gov/pub/irs-utl/asg_penalties_family_limited_pships_finalredacted10_20_06.pdf) [hereinafter SETTLEMENT GUIDELINES] (noting that although the Appeals Settlement Guidelines were issued by IRS Appeals, IRS Compliance has not published a coordinated issue paper, and as such, additional findings may deviate from the topics and conclusions presented). The IRS’s heightened review of FLPs in the early 1990s correlated to their increased use as a means to transfer passive assets that are easily liquidated. *Id.* Commenting on the increased use of the FLP in estate planning, Aileen Condon, chief of the estate and gift-tax program in the IRS’s small business/self-employment division, stated that the use of FLPs as a tax shelter was a “significant area of abuse.” Rachel Emma Silverman & Tom Herman, *IRS Steps up Scrutiny of Family Partnerships: Agency Uses Tougher Tactics to Gauge Legitimacy of Popular Tax Strategy*, WALL ST. J., Jan. 25, 2006, at D1.

15. *Peracchio v. Comm’r*, 86 T.C.M. (CCH) 412, 414 (2003). The notice of deficiency was grounded in four distinct arguments: (1) an economic substance argument; (2) section 2703(a)(2); (3) section 2704(b); and (4) the general valuation rule of section 2512. *Id.*

government determined the most effective approach, it abandoned the remaining three rationales articulated in the deficiency notice.<sup>16</sup> In other cases, the IRS has attempted to attack FLPs by employing a range of theories, which yield uncertain results.<sup>17</sup> There is, therefore, a need for judicial clarification concerning FLPs, especially as they become more popular as estate planning tools.<sup>18</sup>

### B. Valuation of Limited Partnership Interests

The increased use of FLPs is mainly attributed to the valuation discounts that are available under the structure of that entity.<sup>19</sup> When valuing limited partnership interests, the fair market value of the underlying assets is determined and then applicable discounts, which reduce the market value, are deducted.<sup>20</sup> The fair market value of property is “the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.”<sup>21</sup> Discounts are applied to reflect a minority interest status or a lack of marketability that accompany assets held in limited partnership arrangements.<sup>22</sup>

Minority discounts are granted to account for the taxpayer’s lack of control over an entity.<sup>23</sup> Factors supporting the application of minority discounts

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16. *Id.* After some discussion, the tax court applied a six percent minority interest discount and determined that a twenty-five percent marketability discount was appropriate. *Id.* at 419.

17. *See, e.g., Knight v. Comm’r*, 115 T.C. 506, 520 (2000) (Foley, J., concurring) (observing that the IRS is asserting multiple arguments to attack the increased use of FLPs for estate planning).

18. *See id.* (“It is important that we clarify the law in this area with a careful statement of the applicable principles.”).

19. *See Hellwig, supra* note 10, at 277–78 (explaining that valuation discounts are applied because of “the requirement that ‘value’ be measured on an objective basis”).

20. *See, e.g., Estate of Jones v. Comm’r*, 116 T.C. 121, 131 (2001). The IRS has attempted to supply valuation guidelines through revenue rulings that outline the appraisal considerations for closely held business interests. *See, e.g., Rev. Rul. 59-60*, 1959-1 C.B. 237, 241–42, *modified by, Rev. Rul. 65-193*, 1965-2 C.B. 370, 370, *further amplified by, Rev. Rul. 77-287*, 1977-2 C.B. 319, 321, *and Rev. Rul. 83-120*, 1983-2 C.B. 170, 170.

21. *Treas. Reg. § 25.2512-1* (1992); *see also Treas. Reg. § 20.2031-1(b)* (1968). In determining the value of property for the purpose of federal gift tax, both the buyer and seller are depicted as hypothetical individuals aiming to achieve the greatest economic advantage. *Peracchio*, 86 T.C.M. (CCH) at 414.

22. Michael V. Bourland et al., *Maintaining/Operating the Family Limited Partnership*, in *AM. LAW INST.-AM. BAR ASSOC., ESTATE PLANNING FOR THE FAMILY BUSINESS OWNER* 457, 463 (2001).

23. *See Lurie & Shuck, supra* note 9, at 268. When assessing control, the particular interest being considered, whether general or limited, will alter the evaluation for determining the appropriate minority interest. *Id.* at 268–69. For example, a minority interest discount will often be awarded to a limited partner who is subject to more restrictions; however, a general partner, who exercises greater control under the instrument through more extensive voting rights and the ability to liquidate, will not be afforded a minority discount. *Id.*

include lack of managerial control, inability to vote, and limitations imposed on an individual's capacity to transfer partnership interests to a third party.<sup>24</sup> A hypothetical buyer under such circumstances would solicit a lower price, one that is "below the [net asset value] of the pro rata share of the interest purchased" in the limited partnership.<sup>25</sup> In addition to discounts related to minority interest status,<sup>26</sup> limited partnership interests may also enjoy lack of marketability discounts.

Lack of marketability discounts reflect an asset's diminished appeal and increased difficulty to resell.<sup>27</sup> The discount is applicable for both majority and minority interests held in a limited partnership.<sup>28</sup> When calculating a lack of marketability discount, three different approaches are available: (1) comparing "the sales of restricted shares of publicly traded companies . . . to the sales of unrestricted shares in these publicly traded companies"; (2) comparing "[t]he sales of closely held company shares . . . to the prices of subsequent initial public offerings of the same company's share"; or (3)

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24. *Id.* at 267. For example, a hypothetical buyer would not have contributed to the partnership's investment strategy nor could he recover invested assets through unilateral efforts. *See, e.g., Peracchio*, 86 T.C.M. (CCH) at 415. Even when a reduction in value is not permanent, discounts may still be applicable to reduce the transfer of taxes imposed. *See In re Estate of Hjersted*, 175 P.3d 810, 821-23 (Kan. 2008) (ruling that unification of partnership interests had not occurred at the critical time—the date of the transfer—nor did it occur prior to the decedent's death and holding, therefore, that the discounts were neither illusory nor precluded on those grounds).

25. *Estate of Kelley v. Comm'r*, 90 T.C.M. (CCH) 369, 372 (2005). The net asset value is calculated "by totaling the fair market value of all partnership assets and then reducing this gross fair market value amount by the partnership liabilities." D. John Thornton & Gregory A. Byron, *Valuation of Family Limited Partnership Interests*, 32 IDAHO L. REV. 345, 351 (1996). This methodology is solely concerned with the "owning [of] an undivided pro rata interest in the partnership's assets" as it neglects to take into account the "partnership's income earning capabilit[ies]." *Id.* A minority interest discount may be appropriate in certain circumstances; however, the mere holding of a minority share does not automatically trigger the discount. *See, e.g., Estate of Murphy v. Comm'r*, 60 T.C.M. (CCH) 645, 657-58 (1990) (holding that a minority interest discount was inapplicable when the decedent made a gift of 0.88% of stock to each of her children eighteen days before her death in order give herself a minority share in the closely held corporation). The *Murphy* court held that "[a] minority discount should not be applied if the explicit purpose and effect of fragmenting the control block of stock was solely to reduce Federal tax." *Id.* at 658.

26. Although the IRS now acknowledges that minority discounts apply to family-controlled entities, this concession is a recent development. *Compare* Rev. Rul. 93-12, 1993-1 C.B. 202, 203 (overruling Revenue Ruling 81-253 and finding that the presence of a closely held family corporation will not preclude the issuance of minority discounts for the entity's interests), *with* Rev. Rul. 81-253, 1981-2 C.B. 187, 187 (articulating the old rule that precludes the application of minority discounts when simultaneous stock transfers are made in a closely held family corporation).

27. *See Hjersted*, 175 P.3d at 817 (explaining that a lack of marketability discount reflects the illiquidity of the asset's interest due to the reduced pool of potential purchasers). A lack of marketability discount should be applied when "there is not a ready market for partnership interests in a closely held partnership." *Kelley*, 90 T.C.M. (CCH) at 372.

28. *Lurie & Shuck, supra* note 9, at 257.

assessing the “projected estimated costs of making a public offering.”<sup>29</sup> Because minority and lack of marketability discounts can greatly reduce an individual’s taxable estate or the gift tax attached to the transfer of property, the IRS has endeavored to minimize those discounts when FLPs act as tax shelters.<sup>30</sup>

When determining the appropriateness of an asserted valuation and discounts in most cases, a court will consider expert testimony on the fair market value of the gift.<sup>31</sup> Both the taxpayer and the Commissioner proffer expert testimony, each hoping that the court will adopt their expert’s determinations.<sup>32</sup> Although the court is permitted to consider expert opinions when determining valuation, it also has discretion to allocate the weight that should be afforded to each factor being weighed; further, the court is not obligated to rely on the valuation given by either party’s expert when drawing a conclusion.<sup>33</sup> Estimates for both the fair market value and any applicable discounts must be assessed when determining the overall value of partnership interests.<sup>34</sup>

### *C. Go Fish: IRS’s Approaches to Eliminating or Minimizing Discounts Afforded to Family Limited Partnership Interests*

#### *1. Economic Substance Doctrine*

The economic substance doctrine, which focuses on the actual presence or absence of a legitimate business purpose rather than the apparent form of the transaction,<sup>35</sup> was one of the IRS’s early attempts to minimize the application

29. *Id.* at 260.

30. See Silverman & Herman, *supra* note 14, at D1. The IRS has focused its efforts on curtailing those entities that they consider “abusive [tax] shelters, or transactions with no real economic purpose other than evading taxes.” *Id.*

31. Estate of Jones v. Comm’r, 116 T.C. 121, 131 (2001).

32. *Id.*; Lappo v. Comm’r, 86 T.C.M. (CCH) 333, 335 (2003) (quoting Estate of Davis v. Comm’r, 110 T.C. 530, 538 (1998)) (“The persuasiveness of an expert’s opinion depends largely upon the disclosed facts on which it is based.”).

33. See Jones, 116 T.C. at 131; see also Estate of Kelley v. Comm’r, 90 T.C.M. (CCH) 369, 371 (2005) (noting that the trier of fact must consider all relevant facts relating to value when evaluating expert opinions).

34. Bourland et al., *supra* note 22, at 462.

35. See Knight v. Comm’r, 115 T.C. 506, 522 (2000) (Foley, J., concurring). Courts have recognized that

where . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

Casebeer v. Comm’r, 909 F.2d 1360, 1363 (9th Cir. 1990) (citing Frank Lyon Co. v. United States, 435 U.S. 561, 583–84 (1978)). When applying the economic substance doctrine, the IRS explained in a Field Service Advisory that “[t]he simple expedient of drawing up papers does not

of valuation discounts in FLP interests.<sup>36</sup> In the context of estate planning mechanisms, courts generally find this doctrine inapplicable to support the disallowance of valuation discounts.<sup>37</sup> FLPs and other estate planning tools seek to minimize taxes and often include donative intra-family transfers,<sup>38</sup> therefore, the underlying business purposes proffered by an FLP are often dubious.<sup>39</sup> Furthermore, if taxpayers are “willing to burden their property with binding legal restrictions that, in fact, reduce the value of such property” the court must respect those restrictions as an “economic reality.”<sup>40</sup>

In *Knight v. Commissioner*, the court rejected the IRS’s lack of economic substance argument despite the partnership’s failure to show a demonstrated business purpose.<sup>41</sup> The court reasoned that the form and substance of the transaction were not adamantly opposed for the purposes of a gift tax valuation because a willing buyer would consider the establishment of the partnership entity.<sup>42</sup> The validity of the partnership’s business purpose was suspect in that no records were kept, no annual reports were created, no employees were hired, no loans were taken out or given, and no business activities were conducted.<sup>43</sup> Despite these adverse facts, the tax court upheld the validity of the partnership’s restrictions when making valuation determinations.<sup>44</sup> The IRS’s inability to succeed on an economic substance theory forced it to explore alternative means of undermining discount valuations of partnership interests.

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control for tax purposes when the objective economic realities are to the contrary.” I.R.S. Field Serv. Adv. Mem. 2001-43-004 (Nov. 5, 2001), *reprinted in* 15 TAX ANALYSTS 5686, 5689 (2001).

36. See Hawblitzel, *supra* note 8, at 603 (“One of the first tactics the IRS used to prevent the family limited partnership’s estate tax avoidance was the economic substance doctrine, also known as the substance-over-form doctrine.”).

37. See, e.g., *Knight*, 115 T.C. at 522 (Foley, J., concurring) (explaining that the economic substance doctrine is generally inapplicable “in a tax regime dealing with typically donative transfers”).

38. See *id.* (noting that estate planning focuses on tax minimization by donative transfers); see also Hawblitzel, *supra* note 8, at 602–03 (observing that FLPs provide a means to avoid steep estate taxes).

39. See, e.g., *Knight*, 115 T.C. at 522 (Foley, J., concurring).

40. *Id.*

41. *Id.* at 513–14 (majority opinion).

42. *Id.* at 514. When making this determination the court also emphasized that the rights and restrictions existing in the FLP’s structure were valid and enforceable under Texas law. *Id.* at 513–14. The IRS later found fault with this analysis determining that an FLP’s compliance with state law formalities does not support a finding that the FLP must be recognized for transfer tax purposes. I.R.S. Field Serv. Mem. 2001-43-004 (Nov. 5, 2001), *reprinted in* 15 TAX ANALYSTS 5686, 5691 (2001) (“We do not agree that merely because state law formalities were followed when a statutory entity . . . was created that sufficient justification exists for concluding that an entity must be recognized for transfer tax purposes.”).

43. *Knight*, 115 T.C. at 511.

44. *Id.* at 514–15 (“[T]he substance and form of the transaction are not at odds for gift tax valuation purposes.”).



## 2. Section 2704: Restrictions on Liquidation Disregarded

The Commissioner's use of IRC section 2704(b) proved to be as futile as the economic substance doctrine in minimizing valuation discounts under FLPs as the economic substance doctrine. Courts have interpreted section 2704(b) to provide that when there is a family-controlled partnership, "a restriction on the right to liquidate the partnership shall be disregarded when determining the value of the partnership interest that has been transferred by gift or bequest if, after the transfer, the restriction on liquidation either lapses or can be removed by the family."<sup>45</sup> While the IRS has attempted to use section 2704(b) to disregard restrictions concerning liquidation, section 2704(b) only applies when a restriction is deemed to be "applicable" under the statute and pertinent treasury regulations.<sup>46</sup>

In *Kerr v. Commissioner*, the taxpayers created two FLPs with interests allocated to themselves and to their children.<sup>47</sup> The United States Court of Appeals for the Fifth Circuit held that because the restrictions were not removable by the family, the restrictions enumerated in the partnership agreement were not "applicable restrictions" under section 2704(b)(2)(B)(ii) and, therefore, the section 2704(b) special valuation rule did not apply.<sup>48</sup> Although the IRS has been ineffective in its use of both section 2704(b) and the economic substance doctrine to curb the use of FLPs to minimize tax burdens, it has enjoyed success using other bases.

## 3. Section 2036: Retained Interest

Although the IRS has had limited success in attacking the valuation discounts afforded under FLPs, it has been able to curtail the tax advantages granted under these estate planning measures when the transferor retains an

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45. Estate of Jones v. Comm'r, 116 T.C. 121, 128–29 (2001); see also I.R.C. § 2704(b) (2006) (articulating when "certain restrictions on liquidation [are] disregarded").

46. See Leslie Bounds, Note, *Family Limited Partnerships: The Parts Can be Worth Less Than the Whole*—Lappo v. Commissioner, 24 MISS. C. L. REV. 49, 59–60 (2004); see also I.R.C. § 2704(b); Treas. Reg. § 25.2704-2(b) (1992). A restriction is deemed "applicable" when it is more restrictive than the restrictions imposed by state law. Treas. Reg. § 25.2704-2(b) (1992). In *Estate of Jones v. Commissioner*, the IRS contended that the restrictions written into both partnership agreements were more restrictive than those imposed by applicable state law because each partnership had to exist for thirty-five years and limited partners were excluded from withdrawal or demand of a partner's capital without the partnership's dissolution. *Jones*, 116 T.C. at 129. The tax court relied on *Kerr v. Commissioner* to find that section 2704 did not apply because the restrictions in the partnership agreement were not more limiting than other restrictions mandated under Texas law. *Jones*, 116 T.C. at 130 (citing *Kerr v. Comm'r*, 113 T.C. 449, 472–74 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002)); see also *Knight*, 115 T.C. at 520 (holding that section 2704(b) was inapplicable because the restrictions detailed in the partnership agreement were not more restrictive than those under state law).

47. *Kerr v. Comm'r*, 292 F.3d 490, 491 (5th Cir. 2002).

48. *Id.* at 494. Section 2704(b)(2)(B)(ii) provides that a restriction is applicable when "[t]he transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction." I.R.C. § 2704(b)(2)(B)(ii) (2006).

interest in the transferred property.<sup>49</sup> Section 2036(a)(1) provides that when assessing the gross estate of a decedent, the value of a property interest will be included when the decedent has retained “possession or enjoyment of, or the right to the income from, the property.”<sup>50</sup> Thus, section 2036 is intended “to include in a decedent’s gross estate transfers that are essentially testamentary in nature.”<sup>51</sup>

The applicability of section 2036(a)(1) largely depends on whether, at the time of the transfer of the property, “an express or implied agreement” exists that would allow the transferor to retain possession or enjoyment over the transferred property for the remainder of his life.<sup>52</sup> The burden of showing the absence of such an understanding rests with the taxpayer.<sup>53</sup> In determining whether the taxpayer has retained an interest under section 2036(a)(1), the court weighs “the taxpayer’s standing on both sides of the transaction, the taxpayer’s financial dependence on distributions from the partnership, the partner’s commingling of partnership funds with their own, and the taxpayer’s actual failure to transfer the property to the partnership.”<sup>54</sup> In *Estate of*

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49. See, e.g., *Estate of Korby v. Comm’r*, 471 F.3d 848, 852–54 (8th Cir. 2006) (ruling in favor of the IRS, reasoning that the application of section 2036(a) to the FLP recaptured assets into the decedent’s gross estate, resulting in the assessment of \$503,285 in deficiencies against the taxpayer).

50. I.R.C. § 2036(a)(1) (2006). In *Estate of Erickson v. Commissioner*, the Tax Court held that section 2036(a) recaptured the partnership’s assets into the decedent’s gross estate because the taxpayer was financially dependent on distributions from the partnership, funds were commingled, and there was a delay in transferring assets into the partnership. *Estate of Erickson v. Comm’r*, 93 T.C.M. (CCH) 1175, 1181–82 (2007). Although there was only a delay of a few months in transferring assets to the partnership, the decedent’s failing health suggested that the partnership was merely a means of avoiding estate taxes. *Id.* at 1182.

51. *Harper v. Comm’r*, 83 T.C.M. (CCH) 1641, 1647 (2002) (quoting *Ray v. United States*, 762 F.2d 1361, 1362 (9th Cir. 1985)) (internal quotation marks omitted) (interpreting section 2036).

52. See *Estate of Thompson v. Comm’r*, 382 F.3d 367, 375 (3d Cir. 2004) (citing 26 C.F.R. § 20.2036-1(a)). When determining whether an agreement existed, the court must examine all the facts and circumstances concerning the transfer and the later uses of the property. *Estate of Rector v. Comm’r*, 94 T.C.M. (CCH) 567, 572 (2007).

53. See *Estate of Reichardt v. Comm’r*, 114 T.C. 144, 151–52 (2000); see also *Harper*, 83 T.C.M. (CCH) at 1648 (emphasizing that the burden on the taxpayer is more arduous when the transaction concerns family members).

54. *Estate of Bongard v. Comm’r*, 124 T.C. 95, 118–19 (2005) (citations omitted); see *Reichardt*, 114 T.C. at 152–56 (holding that the testator had retained an interest in his property under section 2036 when he transferred all of his assets into the partnership, had exclusive control over the trust, and commingled partnership and personal funds); *Estate of Schauerhamer v. Comm’r*, 73 T.C.M. (CCH) 2855, 2857–58 (1997) (applying section 2036 to find that the value of the decedent’s partnership interest should be included in her gross estate because she had commingled her personal funds and partnership funds). The absence of any one factor articulated in *Bongard* will not prevent a finding of retained personal interest under section 2036. *Bongard*, 124 T.C. at 130–31 (holding that an implied agreement existed and that this agreement allowed the decedent to retain enjoyment of the limited partnership assets even though he did not depend on the assets for living expenses).

*Bongard v. Commissioner*, the IRS succeeded in using section 2036 to challenge the use of an FLP as an estate planning mechanism,<sup>55</sup> but the effect of section 2036(a)(1) on limited partnerships is nevertheless circumscribed by the existence of two exceptions—one implicit in the statute, and one that is specifically enumerated.

First, under the implicit exception, a taxpayer may avoid the application of section 2036(a)(1) by showing that the “decedent did not retain ‘the possession or enjoyment’” of the transferred property.<sup>56</sup> Second, section 2036(a) explicitly includes a parenthetical exception providing that the transferred property will not be included in the gross estate when there has been a “bona fide sale for an adequate and full consideration in money or money’s worth.”<sup>57</sup> In *Kimbell v. United States*, the taxpayer formed a limited partnership that consisted of cash totaling \$2.5 million, oil and gas interests, securities, and other assets.<sup>58</sup> Although the IRS contended that the partnership was subject to section 2036(a), the United States Court of Appeals for the Fifth Circuit concluded that the bona fide sale exception applied, thereby excluding the partnership assets from the gross estate.<sup>59</sup> The court reasoned that the partnership qualified for the explicit parenthetical exception because the decedent had retained adequate assets not included in the partnership, no commingling of funds occurred, the partnership formalities were satisfied, and the assets in the partnership required active management.<sup>60</sup> Additionally, the taxpayers in *Kimbell* advanced several non-tax business reasons for the creation of the partnership, including protection from creditors and the

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55. See Schwidetzky, *supra* note 2, at 298. *Bongard* delivered a devastating blow to taxpayers because the IRS displayed its willingness to attack FLP structures that were not created in anticipation of the decedent’s impending death. *Id.* at 298–99. The decedent in *Bongard* was fifty-eight years old and in good health when he died unexpectedly on an international business and hunting trip. *Bongard*, 124 T.C. at 98–99. Although the decedent did not commingle funds and maintained adequate assets outside of the partnership for his living expenses, the IRS ultimately prevailed using section 2036(a) to find an implied agreement that permitted the decedent to enjoy property held in the FLP. *Id.* at 130–31. *Bongard* marked a significant win for the IRS because the court’s decision increased the decedent’s estate tax by \$50 million. Schwidetzky, *supra* note 2, at 303.

56. See *Estate of Bigelow v. Comm’r*, 503 F.3d 955, 964 (9th Cir. 2007) (interpreting I.R.C. § 2036(a)(1)).

57. I.R.C. § 2036(a). In order to qualify for this exception, the decedent’s transfer must have been conducted in good faith and “the price must have been an adequate and full equivalent reducible to a money value.” Treas. Reg. § 20.2043-1(a) (1968). In this context, “good faith” means that the transfer was made for a “legitimate and significant nontax business purpose.” *Estate of Rector v. Comm’r*, 94 T.C.M. (CCH) 567, 573 (2007); see also *Estate of Rosen v. Comm’r*, 91 T.C.M. (CCH) 1220, 1232 (2006) (ruling that the rationale for creating the partnership must be authentic and not a “theoretical justification”).

58. *Kimbell v. United States*, 371 F.3d 257, 259 (5th Cir. 2004).

59. *Id.* at 269.

60. *Id.* at 267. Although retention of assets outside the partnership is persuasive in avoiding the applicability of section 2036(a), this fact alone is not dispositive. See Schwidetzky, *supra* note 2, at 294.

minimization of intra-family disputes.<sup>61</sup> Courts often reject the idea that protection from creditors is a valid non-tax business purpose;<sup>62</sup> however, in *Kimbell*, the FLP held oil and gas interests that were prone to potential litigation concerning environmental hazards and the court found protection from personal liability to be a valid business purpose.<sup>63</sup> Although the explicit parenthetical exception applied in *Kimbell*, other partnership structures were unable to take advantage of the exception's scope.<sup>64</sup>

Section 2036(a) has provided the IRS with its most effective means to attack FLPs. In *Estate of Thompson v. Commissioner*, the ninety-five-year-old decedent transferred ninety-five percent of his assets into two FLPs without retaining sufficient capital to support his cost of living.<sup>65</sup> These facts—coupled with the decedent's receipt of cash distributions from the partnership—supported the court's finding that an implied agreement existed between the decedent and his family and, therefore, section 2036(a) applied.<sup>66</sup> Unlike *Kimbell*, the explicit parenthetical exception did not apply in *Thompson*, because the *Thompson* FLPs failed to engage in any business

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61. *Kimbell*, 371 F.3d at 267–68. The IRS also unsuccessfully argued that there was an inherent inconsistency in the taxpayer's reasoning; the taxpayer contended that the partnership should receive valuation discounts for the assets transferred while simultaneously asserting that the partnership interest was exchanged for full and adequate consideration. *Id.* at 265. The court rejected the government's reasoning, noting that the government had conflated the “willing buyer-willing seller” test with the “adequate and full consideration” test under the explicit parenthetical exception in section 2036(a). *See id.* at 266; *see also Bigelow*, 503 F.3d at 968–69 (finding that the devaluation that inherently accompanies the transfer of assets into an FLP does not per se prohibit the taxpayer from enjoying the explicit parenthetical exception under section 2036(a)); *Harper v. Comm'r*, 83 T.C.M. (CCH) 1641, 1654 (2002) (“[I]t is not unreasonable to assume that a genuine pooling for business purposes injects something different into the adequate and full consideration calculus than does mere, unilateral value ‘recycling’ . . .”). Even when the non-tax business purpose is not fully concrete, the court has allowed the section 2036(a) explicit parenthetical exception to apply. *See Estate of Schutt v. Comm'r*, 89 T.C.M. (CCH) 1353, 1361, 1368 (2005). In *Schutt*, the court accepted the estate's assertion that it formed business trusts with the hope of perpetuating the decedent's adamant buy-and-hold investment philosophy. *Id.* at 1367; *see also Schwidetzky, supra* note 2, at 303–04 (observing that the unusual facts exhibited in *Schutt*, such as the IRS having the burden in the case, might diminish its future precedential value).

62. *See, e.g., Bigelow*, 503 F.3d at 971.

63. *Kimbell*, 371 F.3d at 268. *But see Estate of Rector v. Comm'r*, 94 T.C.M. (CCH) 567, 573 (2007) (declining to acknowledge protection from creditors as a legitimate business purpose when there was no impending liability concern); *Estate of Rosen v. Comm'r*, 91 T.C.M. (CCH) 1220, 1234 (2006) (rejecting protection from creditors as a legitimate purpose to qualify for the section 2036(a) explicit parenthetical exception, reasoning that the decedent's previously created trust would have provided the same protection).

64. *See, e.g., Strangi v. Comm'r*, 417 F.3d 468, 482 (5th Cir. 2005); *Estate of Thompson v. Comm'r*, 382 F.3d 367, 383 (3d Cir. 2004); *Rector*, 94 T.C.M. (CCH) at 574; *Rosen*, 91 T.C.M. (CCH) at 1232; *Harper*, 83 T.C.M. (CCH) at 1653; *Estate of Reichardt v. Comm'r*, 114 T.C. 144, 155–56 (2000).

65. *Thompson*, 382 F.3d at 376.

66. *Id.*

activities and the decedent was not afforded any non tax-based benefits from the structure.<sup>67</sup> Therefore, the United States Court of Appeals for the Third Circuit concluded that section 2036(a) would recapture the assets from the FLPs and include them in the decedent's gross estate.<sup>68</sup> When a court finds that the partnership is being used as an "alternate testamentary vehicle" for the mere "recycling of value," the assets transferred into the partnership will be subject to recapture under section 2036(a).<sup>69</sup>

In *Strangi v. Commissioner*, the decedent transferred \$10 million of personal assets into an FLP near the time of his death.<sup>70</sup> The court found that an implied agreement existed between Strangi and his children, shown by Strangi's minimal retention of capital, disbursements made to him from the FLP during his life, his continued physical possession of his home, and the partnership's funding of his unsatisfied debts and funeral expenses.<sup>71</sup> The estate provided legitimate non-tax reasons for the decedent's transfer of assets into the FLP, including creditor protection and the minimization of intra-family litigation<sup>72</sup>—however, the United States Court of Appeals for the Fifth Circuit did not find these purposes sufficiently compelling to satisfy the "bona fide sale" exception.<sup>73</sup> Accordingly, the court held that the transferred assets were "properly included" in the taxable estate.<sup>74</sup> While the IRS has struggled to utilize various statutory or theoretical constructs to combat valuation discounts afforded to FLP assets, section 2036(a) has emerged as the most successful strategy.<sup>75</sup>

#### 4. Expert Appraisals: A Constant Battle

In addition to statutory schemes, the IRS has succeeded in reducing valuation discounts by proffering expert testimony to rebut the asserted valuation of the estate. Even when the IRS is unsuccessful in eliminating all discounts afforded under an FLP structure, it retains the ability to minimize

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67. *Id.*; see *Kimbell*, 371 F.3d at 269.

68. *Thompson*, 382 F.3d at 369.

69. *Harper*, 83 T.C.M. (CCH) at 1652, 1654 (holding that the decedent retained enjoyment of the property transferred into the partnership under section 2036(a) and the explicit parenthetical exception was not applicable because the FLP lacked payment for adequate consideration).

70. *Strangi v. Comm'r*, 417 F.3d 468, 472 (5th Cir. 2005).

71. *Id.* at 474, 476, 478.

72. *Id.* at 480.

73. *Id.* at 482.

74. *Id.*

75. See Rachel Emma Silverman, *IRS Wins Legal Fight Over Estate-Tax Strategy*, WALL ST. J., July 19, 2005, at D2. Following the *Strangi* decision, Norman Lofgren, a lawyer who represented the Strangi estate, commented on the government's victory: "The IRS is going to view this very positively. Let the audits and the litigation begin." *Id.*

them.<sup>76</sup> In *Peracchio v. Commissioner*, the IRS argued that a 4.4% discount for lack of control and a fifteen percent discount for lack of marketability were appropriate.<sup>77</sup> Conversely, the taxpayer's two experts asserted that a 5–7.7% minority discount and a thirty-five to forty percent marketability discount should have been applied.<sup>78</sup> The tax court assessed and rejected the calculations of each party and found that a six percent minority interest discount and a twenty-five percent marketability discount should be used to value the limited partnership interests.<sup>79</sup>

The tax court has recently heightened the sophistication of its methodology when appraising the assets held in an FLP; the new methodology determines the net asset value of the partnership and then analyzes its composition by separately considering each class of assets.<sup>80</sup> For example, in *Estate of Kelley v. Commissioner*, the estate argued that a twenty-five percent minority discount and a thirty-eight percent marketability discount were appropriate.<sup>81</sup> The IRS

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76. The court in *In re Estate of Hjersted* recognized that there is usually a negotiation between the taxpayer and the Commissioner as to the extent of the discounts that should be applied. *In re Estate of Hjersted*, 175 P.3d 810, 819 (Kan. 2008) (quoting Edwin T. Hood et al., *Valuation of Closely Held Business Interests*, 65 UMKC L. REV. 399, 406 (1997)).

77. *Peracchio v. Comm'r*, 86 T.C.M. (CCH) 412, 414 (2003). Both parties' experts calculated the applicable minority interest discount by examining publicly traded, closely held investment funds. *Id.* at 415. These funds provided an adequate comparison because they are highly marketable, and as such, the "discounts must be attributable . . . to a minority shareholder's lack of control." *Id.* After rejecting the analysis of petitioners' experts, the court examined the government's expert in order to find an adequate computation of the marketability discount. *Id.* at 419. Applying the six factors, the government's expert concluded that the marketable securities and cash investments held in the partnership demanded a more limited discount due to their increased liquidity. *Id.*

78. *Id.* at 415. Although the taxpayers' experts both used a similar analysis to that used by the government concerning minority interest discounts, each of the taxpayers' experts used a distinct approach in determining the marketability discount. *Id.* at 415–16, 418. One of the taxpayer's experts relied on the standard range of discounts outlined in *Mandelbaum v. Commissioner*, while the other found support in restricted stock studies. See *Peracchio*, 86 T.C.M. (CCH) at 418 (citing *Mandelbaum v. Comm'r*, 69 T.C.M. (CCH) 2852 (1995), *aff'd*, 91 F.3d 124 (3d Cir. 1996)).

79. *Peracchio*, 86 T.C.M. (CCH) at 419. The court accepted the use of publicly traded, closed-end investment funds as comparables to calculate the applicable minority interest. *Id.* at 416. After the court "expressed [its] dissatisfaction with the experts' respective analyses," it reluctantly concluded that if the IRS's expert determined that a marketability discount above twenty-five percent would not be appropriate, then implicitly the IRS conceded that a discount up to twenty-five percent would be permissible. *Id.* at 419.

80. SETTLEMENT GUIDELINES, *supra* note 14, at 5; see also *Estate of Kelley v. Comm'r*, 90 T.C.M. (CCH) 369, 373–74 (2005) (reflecting the new methodology used by the IRS when appraising assets); *Lappo v. Comm'r*, 86 T.C.M. (CCH) 333, 339 (2003).

81. *Kelley*, 90 T.C.M. (CCH) at 372–73. The estate utilized multiple resources when calculating the applicable minority interest discount. *Id.* at 372. After using closed-end funds in the fourth quartile as baseline comparables, the expert factored in additional discounts based on the FLP's intrinsic restrictions and further partnership studies. *Id.* When establishing an appropriate marketability discount, the estate's expert compared the partnership interests with the common stock of a private, closely held corporation. *Id.* at 373.

maintained that a twelve percent minority discount and a fifteen percent marketability discount should be applied instead.<sup>82</sup> Ultimately, the court held that the limited partnership interests should be valued with a twelve percent minority discount and a twenty-three percent marketability discount.<sup>83</sup> In addition to section 2036(a), competing valuation calculations have been one of the few successful means used by the IRS to diminish the discounts applied to FLP interests. Although the IRS has been thwarted on many of its attacks on abusive FLPs, the tax court recently sanctioned a new statutory means under section 2703(a).

### 5. Section 2703(a): A New Means of Regulation

#### a. Pre-Section 2703 requirements

Under federal law, there is an exception to the general fair-market valuation of a taxable estate when property is sold under a valid buy-sell agreement.<sup>84</sup> In order for property to come within the ambit of this exception, three requirements must be met:

- (1) the offering price must be fixed and determinable under the agreement;
- (2) the agreement must be binding on the parties both during life and after death; and
- (3) the restrictive agreement must

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82. *Id.* at 372, 373. The government, like the estate, embraced an approach that used closed-end funds to ascertain the minority discount; however, the government used the whole collection of closed-end funds instead of solely relying on the numbers from the fourth quartile. *Id.* at 372. When calculating an appropriate marketability discount, the IRS employed a private placement approach that relied heavily on a study conducted by Dr. Mukesh Bajaj. *Id.* at 373. Dr. Bajaj's report determined that "the private placement of unregistered shares has an average discount of about 14.09 percent higher than the average discount on registered placements." *Id.* The government's expert used the Bajaj study in conjunction with the "low risk of the partnership's portfolio" to determine the marketability discount that should be applied. *Id.* The court later concluded that the government's reliance on the Bajaj study was misplaced because the 14.09 percent discount calculation was not solely attributed to a lack of marketability; there were other considerations included in the analysis as well. *Id.*

83. *Id.* at 374. The court concluded that the estate's restricted analysis of closed-end funds in the fourth quartile was inaccurate. *Id.* at 372. Considering that the government maintained that a twelve percent discount would be appropriate and the estate was unpersuasive in advocating for a heightened discount, the court settled on a twelve percent minority discount. *Id.* Furthermore, the court found that the analyses of both parties concerning lack of marketability discounts were flawed. *Id.* at 373. The court made its own assessment derived largely from prior case law. *Id.* at 373-74. Although *Kelley* demonstrates the interplay that occurs between proposed valuations by both the government and the estate, the IRS declared that this case does not hold much precedential value because experts for both the IRS and the estate used general equity closed-end funds as comparables, even though the partnership was comprised solely of cash and certificates of deposit. SETTLEMENT GUIDELINES, *supra* note 14, at 8.

84. *See, e.g., Estate of Blount v. Comm'r*, 428 F.3d 1338, 1342 (11th Cir. 2005) ("Courts have refined the guidance in the regulations into an exception to the general rule for property that is subject to a valid buy-sell agreement.").

have been entered into for a *bona fide* business reason and must not be a substitute for a testamentary disposition.<sup>85</sup>

When analyzing whether pre-section 2703 requirements were satisfied, the court in *Smith v. United States* focused on the decedent's control of property, observing that the decedent owned two-thirds of all the general partnership interests in the FLP before his death, and was therefore able to make unilateral changes under the FLP agreement.<sup>86</sup> Because the decedent could unilaterally alter the terms of the FLP agreement, and the restrictive provisions were not binding during the decedent's life, the restrictive agreement was therefore disregarded for federal gift tax purposes.<sup>87</sup> The third prong of the pre-section 2703 requirements was eventually codified in the Omnibus Budget Reconciliation Act of 1980, which also applied additional restrictions to the pre-section 2703 requirements.<sup>88</sup>

*b. Section 2703: Substantively*

Section 2703 was not enacted to displace pre-existing case law;<sup>89</sup> therefore, the pre-section 2703 requirements still apply.<sup>90</sup> Under section 2703(a), the value of property will be calculated without taking into account: (1) any right to use the property for less than fair market value and (2) any pertinent right or restriction that is associated with the property.<sup>91</sup> Section 2703(b) provides an

85. *Id.* (articulating a three-prong test to determine whether pre-section 2703 requirements are met).

86. *Smith v. United States*, 96 A.F.T.R.2d (RIA) 2005-6549, 2005-6554 (W.D. Pa. 2005).

87. *Id.* at 2005-6553; *see also Blount*, 428 F.3d at 1342, 1344. In *Blount*, the court found that the decedent's sole capacity to alter the stock purchase agreement during his life allowed the restrictive agreement to be disregarded when valuing the assets for estate taxes. *Id.* at 1344 (ruling that the exception to the general rule did not apply and the estate must be valued using fair-market determination). Even if the decedent does not exercise his unilateral right of alteration, the exception nevertheless does not apply because the only pertinent inquiry is whether the decedent has the *capacity* to modify. *Id.* at 1344; *see also Smith*, 96 A.F.T.R.2d (RIA) at 2005-6553-54 n.3 (noting that it is irrelevant whether the transferor actually exercised the ability to alter an FLP agreement and holding that the only relevant point is "that he had the unilateral right to do so").

88. Omnibus Budget Reconciliation Act of 1990 § 11602, 26 U.S.C. §§ 2701-2704 (2006).

89. 136 CONG. REC. 30,488, 30,540-41 (1990) ("The bill does not otherwise alter the requirements for giving weight to a buy-sell agreement. . . . [I]t leaves intact rules requiring that an agreement have lifetime restrictions in order to be binding on death.").

90. *See, e.g., Estate of Amlie v. Comm'r*, 91 T.C.M. (CCH) 1017, 1024 (2006). Section 2703 was enacted in the Omnibus Budget Reconciliation Act of 1990—legislation that was promulgated in an effort to remedy "valuation distortions" afforded under limited liability entities used for estate planning means. 26 U.S.C. §§ 2701-2704; I.R.S. Field Serv. Mem. 2001-43-004 (Nov. 5, 2001), *reprinted in* 15 TAX ANALYSTS 5658, 5694 (2001). Although Congress recognized the legitimate use of minority interest and marketability discounts when reflecting restrictions inherent in a structure, it sought to curtail the abusive use of valuation discounts in the context of intra-family partnerships. I.R.S. Field Serv. Mem. 2001-43-004 (Nov. 5, 2001), *reprinted in* 15 TAX ANALYSTS at 5694.

91. I.R.C. § 2703(a) (2006).



exception to subsection (a) when a restriction meets the following requirements:

- (1) It is a bona fide business arrangement[;]
- (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth[; and]
- (3) Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.<sup>92</sup>

Although the IRS has attempted to use section 2703 to negate the discounts applied to partnership interests burdened with restrictions, prior case law suggests that the safe-harbor provision outlined in section 2703(b) would alleviate the harsh tax consequences of section 2703(a).<sup>93</sup> In *Church v. United States*, an FLP was created for the primary purpose of preserving the family's ranching venture.<sup>94</sup> The assets transferred to the FLP consisted of "each limited partner's undivided interest" in the family ranch and the decedent's contribution of securities worth \$1 million.<sup>95</sup> The IRS attempted to use section 2703 to disregard the restrictions imposed under the partnership agreement; however, the restrictions were nevertheless considered in the assets' valuation because each requirement of section 2703(b) was satisfied.<sup>96</sup>

In *Estate of Amlie v. Commissioner*, the IRS issued an estate tax deficiency on valuations that had been allocated to certain stocks and real property held by the decedent.<sup>97</sup> Due to intra-family contentions concerning the price of the stock, the decedent's prospective heirs adopted a family settlement agreement in 1995 (1995 FSA) that solidified the price of the stock for the decedent and his prospective heirs.<sup>98</sup> The IRS sought to apply section 2703, but the taxpayer succeeded in satisfying all three requirements under the safe-harbor exception of section 2703(b).<sup>99</sup> First, the tax court recognized that the bona fide business arrangement prong was satisfied by the decedent's minimization of the

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92. *Id.* § 2703(b).

93. *See, e.g., Amlie*, 91 T.C.M. (CCH) at 1028; *Church v. United States*, 85 A.F.T.R.2d (RIA) 2000-804, 2000-808 (W.D. Tex. 2000), *aff'd*, 268 F.3d 1063 (5th Cir. 2001).

94. *Church*, 85 A.F.T.R. (RIA) at 2000-805.

95. *Id.*

96. *Id.* at 2000-808. The government also argued that "property" referred to the underlying assets that the decedent had originally contributed to the partnership instead of referring to her partnership interest. *Id.* at 2000-810. The court concluded that section 2703 does not support this meaning of "property"; but rather, "property" under section 2703 refers to the partnership interests that the decedent owned at the time of her death. *Id.*; *see also* I.R.C. § 2033 (providing that the pertinent time to measure one's gross estate is at the time of death, without any concern for the nature of the property interests prior or subsequent to death).

97. *Amlie*, 91 T.C.M. (CCH) at 1023.

98. *Id.* at 1021.

99. *Id.* at 1028. Prior to applying the section 2703(b) test, the court recognized that the 1995 FSA complied with all three of the pre-section 2703 requirements. *Id.* at 1025.

potential risks that existed in his minority interest in a closely held bank.<sup>100</sup> Second, the court found that the decedent had received adequate consideration in a fixed price for a minority stock interest, which was afflicted with the potential of pending litigation and the ambiguity surrounding the value;<sup>101</sup> and as such, the 1995 FSA was not categorized as a testamentary device under the second requirement of section 2703(b).<sup>102</sup> Finally, the estate's expert demonstrated satisfaction of section 2703(b)(3) by comparing the 1995 FSA to a 1994 agreement that had been entered into during an arm's-length transaction.<sup>103</sup> Because the estate was successful in satisfying all of the requirements under section 2703(b), the court held that under section 2703(a), it would not disregard the 1995 FSA for valuation purposes.<sup>104</sup>

## II. HOLMAN'S IMPACT ON THE VALUATION OF LIMITED PARTNERSHIP INTERESTS

Although the IRS had been unsuccessful in attacking FLPs under section 2703, a May 2008 case, *Holman v. Commissioner*,<sup>105</sup> finally provided the government another means of curtailing the effectiveness of FLPs as an estate planning instrument. When drafting estate plans, attorneys must be aware of the intricacies of certain instruments, so as to ensure that the purported advantages will be actualized. The starting point for structuring effective FLPs is found in the IRC, its applicable regulations, and pertinent revenue and private letter rulings; evolving case law provides substantive guidance on the way that courts will resolve contentious issues.<sup>106</sup> Inconsistency in the law governing FLPs is largely rooted in the IRS's inability to craft a uniform approach to measuring the validity of these structures.<sup>107</sup> The fact-specific nature of FLP inquiries makes it difficult to predict the outcome with consistency.<sup>108</sup> In both *Amlie* and *Church*, the courts allowed taxpayers to use section 2703(b) to incorporate the FLP's restrictions when determining the

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100. *Id.* at 1026.

101. *Id.*

102. *Id.* at 1027.

103. *Id.* Although the IRS argued that the basis for the taxpayer's satisfaction of the third prong was insufficient because it was based on "isolated comparables," the court rejected this theory and found the estate's expert testimony sufficient to satisfy the requirement. *Id.* (recognizing that although regulations show a preference for multiple comparables, they are not an absolute requirement).

104. *Id.* at 1028.

105. *Holman v. Comm'r*, 130 T.C. 170 (2008).

106. *See, e.g.*, *Estate of Bigelow v. Comm'r*, 503 F.3d 955, 964 (9th Cir. 2007); *Strangi v. Comm'r*, 417 F.3d 468, 472 (5th Cir. 2005); *Estate of Thompson v. Comm'r*, 382 F.3d 367, 369 (3d Cir. 2004); *Estate of Bongard v. Comm'r*, 124 T.C. 95, 131 (2005).

107. *See Knight v. Comm'r*, 115 T.C. 506, 520 (2000) (Foley, J., concurring) (observing that "taxpayers are planning amid great uncertainty" when utilizing the FLP device).

108. SETTLEMENT GUIDELINES, *supra* note 14, at 2-3 (noting the multiple theories advanced by the IRS to evaluate the validity of an FLP).

value of the transferred assets.<sup>109</sup> However, in *Holman*, the tax court applied section 2703(a) to an FLP, finding that the safe-harbor requirements under subsection (b) were not satisfied.<sup>110</sup>

In *Holman*, husband and wife petitioners established the Holman Limited Partnership.<sup>111</sup> Under the structure of the partnership, the petitioners served as both general and limited partners, and one of the petitioner's mother served as a limited partner, acting as the separate custodian for each of the petitioners' children.<sup>112</sup> As general partners, the petitioners were solely responsible for the management of the partnership.<sup>113</sup> Limited partners were restricted in their dealings concerning partnership assets under paragraphs 9.1–9.3 of the FLP agreement.<sup>114</sup> The taxpayers' articulated purpose for forming the partnership was "to make a profit, increase wealth, and provide a means for the Family to gain knowledge of, manage, and preserve Family Assets."<sup>115</sup> In December 1999, petitioners transferred 10,030 shares of Dell stock into the partnership's account.<sup>116</sup> In its analysis, the court noted that the partnership's assets were solely comprised of Dell stock that the taxpayer had acquired through his job.<sup>117</sup> This transfer was followed by subsequent smaller gifts of limited

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109. *Amlie*, 91 T.C.M. (CCH) at 1028; *Church v. United States*, 85 A.F.T.R.2d (RIA) 2000-804, 2000-811 (W.D. Tex. 2000), *aff'd*, 268 F.3d 1063 (5th Cir. 2001).

110. *Holman*, 130 T.C. at 199 (ruling that the FLP was not a "bona fide business arrangement" and thus section 2703(b)(1) was not satisfied).

111. *Id.* at 174.

112. *Id.*

113. *Id.* at 176.

114. *Id.* at 176–78. Limited partners were not allowed to voluntarily or involuntarily assign all or a fraction of their interest in the partnership without the written consent of all partners. *Id.* at 176. There were some exceptions to this rigid general rule. A limited partner could assign an interest to a custodian of a family member, to trustees holding property in a trust instrument for family members, and to a revocable trust where all of the beneficial interest is owned by the partner. *Id.* Limited partners were further restricted in that dissolution of the entity required the written consent of all partners. *Id.* at 178 (stating that the partnership would dissolve when written consent was given by all partners or on December 31, 2049, whichever occurred first).

115. *Id.* at 175–76.

116. *Id.* at 179.

117. *Id.* at 172, 182. Although the taxpayers' creation and funding of the partnership occurred only six days prior to the first gift of partnership interests, the court refused to treat the two actions as occurring simultaneously under the step transaction doctrine. *Id.* at 190–91. The step transaction doctrine applies when "an interrelated series of steps are taken pursuant to a plan to achieve an intended result." *Id.* at 187 (quoting *Packard v. Comm'r*, 85 T.C. 397, 420 (1985)); see also *Bourland et al.*, *supra* note 22, at 477. The doctrine is premised on an entity's apparent use as an abusive tax shelter when gifts are being made near in time to the FLP's inception. *Bourland et al.*, *supra* note 22, at 477. The step transaction is implicit in the gift tax statute, and as such, courts may apply the step transaction doctrine when assessing federal tax liability. See *Senda v. Comm'r*, 433 F.3d 1044, 1048 (8th Cir. 2006) ("This step-transaction doctrine is 'impliedly included in the gift tax statute itself.'" (quoting *Sather v. Comm'r*, 251 F.3d 1168, 1174 (8th Cir. 2001))). In *Senda*, the United States Court of Appeals for the Eighth Circuit upheld the tax court's determination that the step transaction doctrine applied when the taxpayers

partnership interests in 2000 and 2001.<sup>118</sup>

From the time of its inception until 2001, the partnership lacked a business plan.<sup>119</sup> Additionally, the partnership did not pay any employees, had not prepared annual statements, and was not listed in the telephone directory.<sup>120</sup> The partnership neither reported any income nor filed federal income tax returns for 1999, 2000, and 2001.<sup>121</sup> The IRS argued that the restrictions enumerated under the petitioner's FLP agreement should be disregarded in accordance with section 2703(a).<sup>122</sup> Although the section 2703(b) safe-harbor exception had proved useful in protecting other partnerships from the application of section 2703(a), the IRS was finally successful in applying section 2703(a) to invalidate the discounts in the Holmans' FLP.<sup>123</sup> The ramifications of *Holman* on future estate planning instruments are driven by the court's underlying rationale for denying the application of the section 2703(b) safe-harbor exception.

### III. *HOLMAN*: SECTION 2703 AND THE MUDDYING OF THE WATERS

Section 2501(1) of the IRC requires that a tax be paid on any transfer of property gifted throughout the duration of the year.<sup>124</sup> Under section 2703(a), the value of the gifted property will be calculated for gift tax purposes without consideration given to any option to acquire the property for less than fair market value, or any right or restriction imposed on the property through the structure of the arrangement.<sup>125</sup> While the taxpayers in *Holman* attempted to

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created the Senda & Associates, L.P. on December 17, 1999, and three days later gifted 53.7% of the partnership's limited interest to trusts for their three children. *Id.* at 1045–46, 1048–49. Although the *Holman* FLP was created six days prior to the gifting of limited partnership interests, the court refused to apply the step transaction doctrine because of the tangible economic risk inherent in the unpredictable and heavily-traded Dell stock that comprised the partnership's assets. *Holman*, 130 T.C. at 191 n.7.

118. *Holman*, 130 T.C. at 179, 181.

119. *Id.* at 181.

120. *Id.* at 182.

121. *Id.*

122. *Id.* at 183–84.

123. *Id.* at 191, 215–16.

124. I.R.C. § 2501(a) (2006). A gift of property is valued as of the date of the transfer. I.R.C. § 2512(a).

125. I.R.C. § 2703(a). All of the partners under the *Holman* FLP were family members; therefore, for the exception to apply, each prong of section 2703(b) must have been met. *Holman*, 130 T.C. at 174, 191; see also Lurie & Shuck, *supra* note 9, at 279. On the other hand, rights or restrictions may not have to pass muster under section 2703(b) when the FLP contains partners that are non-family members. See Treas. Reg. § 25.2703-1(b)(3) (1992). A presumption that section 2703(b) is satisfied arises when more than fifty percent of the value subject to the right or restriction is held either directly or indirectly by persons unrelated to transferor—as defined in Treasury Regulations. See *id.* § 25.2701-2(b)(5); Lurie & Shuck, *supra* note 9, at 279. In order to take advantage of this exception, both the property held by the transferor and the property held by the unrelated party must be subject to the same degree of right or restriction.

avoid the application of section 2703(a) by using the statutory exception in subsection (b), their efforts proved futile.<sup>126</sup>

#### A. *Bona Fide Business Arrangement*

Although section 2703 does not define “bona fide business arrangement,”<sup>127</sup> courts have previously held that a strict construction of this phrase may not be necessary because the restrictive agreement does not have to specifically concern an “actively managed business.”<sup>128</sup> Even under this more flexible interpretation, the IRS in *Holman* contended that paragraph 9.3 of the partnership agreement did not qualify as part of a bona fide business arrangement because holding securities and maintaining records, without more, are insufficient business activities.<sup>129</sup> Furthermore, the IRS argued that the purposes advanced by petitioners—to educate their children about building family wealth and to inhibit them from inappropriate spending—were “personal, not business[,] goals.”<sup>130</sup> The petitioners countered the government’s argument by asserting that “[t]he restrictions on transferability, the right of first refusal, and the payout mechanism in paragraphs 9.1, 9.2, and 9.3 of the Partnership Agreement serve a bona fide business purpose . . . by preventing interests in the Partnership from passing to non-family members.”<sup>131</sup> Although legislative history recognizes that buy-sell agreements are often created for legitimate business purposes,<sup>132</sup> the *Holman* court found that this partnership was not a closely held business because the partnership failed to engage in activities other than the management of their Dell stock.<sup>133</sup> Therefore, there was not a bona fide business arrangement under section

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Lurie & Shuck, *supra* note 9, at 279. When such a composition of ownership is found, then the right or restrictions applied will not be disregarded for valuation purposes under a section 2703(a) analysis. *See id.*

126. *Holman*, 130 T.C. at 191, 215–16.

127. *Id.* at 192.

128. *See* Estate of Amalie v. Comm’r, 91 T.C.M. (CCH) 1017, 1026 (2006) (finding that “an agreement that represents a fiduciary’s efforts to hedge the risk of the ward’s holdings may serve a business purpose within the meaning of section 2703(b)(1)”).

129. *Holman*, 130 T.C. at 192.

130. *Id.* (alteration in original).

131. *Id.*

132. *See* 136 CONG. REC. 30,488, 30,539 (1990). A report from the Senate Committee on Finance recognized that

[b]uy-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.

*Id.*

133. *Holman*, 130 T.C. at 194–95. The court distinguished this case from *Amalie* by noting that in *Holman* there was no closely held business to protect and the reasons stipulated by the petitioners for forming the FLP did not match those enumerated by Congress. *Id.*

2703(b)(1).<sup>134</sup> Even though the Holman FLP failed to meet the first prong of section 2703(b)—a failure that precludes the application of section 2703(b)—the court nevertheless analyzed the second and third prongs,<sup>135</sup> reaching no conclusion on the third.<sup>136</sup>

### B. Device Test

The second prong of the section 2703(b) safe-harbor exception provides that a right or restriction cannot be a device for intra-family property transfers for less than full and adequate consideration.<sup>137</sup> The *Holman* court held that the limited partnership units were “natural objects of petitioners’ bounty”<sup>138</sup> that were transferred “for less than adequate consideration,”<sup>139</sup> and that it was necessary to determine whether the restrictions on the children’s limited partnership units were a “device” to transfer partnership interests for “less than adequate consideration.”<sup>140</sup> The court concluded that paragraph 9.3 allowed for the petitioners, as general partners, to redistribute wealth to other limited partners when there was a child who had engaged in a prohibited transfer; therefore, paragraph 9.3 served as a device to transfer limited partnership interests for less than adequate consideration.<sup>141</sup>

### C. Comparable Terms

The third prong of the section 2703(b) safe-harbor exception requires the court to assess whether the terms of the restriction are comparable to other arm’s-length arrangements.<sup>142</sup> Expert testimony is often used to establish this third requirement because comparable arrangements are needed to evaluate the relation between other structures and the FLP in question.<sup>143</sup> In *Holman*, the IRS maintained that in an arm’s-length transaction, it was unlikely that an

134. *Id.* at 195.

135. *Id.* at 195–99.

136. *Id.* at 199.

137. I.R.C. § 2703(b)(2) (2006). When viewed alongside its regulations, section 2703 seems to have been interpreted to apply to both testamentary and inter vivos transfers. *Holman*, 130 T.C. at 195–96; *see also* Treas. Reg. § 25.2703-1(b)(1)(ii) (1992). This reading is apparent because the regulations replaced the term “members of the decedent’s family” located in the statute with “the natural objects of the transferor’s bounty.” *Compare* I.R.C. § 2703(b)(2), with Treas. Reg. § 25.2703-1(b)(1)(ii).

138. *Holman*, 130 T.C. at 196.

139. *Id.*

140. *Id.* at 196–97.

141. *Id.* at 197.

142. I.R.C. § 2703(b)(3). When making this determination, the relevant point of comparison is at the creation of the restriction. Treas. Reg. § 25.2703-1(b)(1)(iii) (1992).

143. *See, e.g.*, Estate of Amlie v. Comm’r, 91 T.C.M. (CCH) 1017, 1027 (2006) (using expert testimony from an attorney skilled in the buying and selling of closely held equity interests to determine that the disputed 1995 FSA was indistinguishable from a 1994 agreement created through an arm’s-length transaction).

individual would agree to the restrictions set out in the partnership agreement, particularly because the limited partners were not able to sell their interests for fifty years.<sup>144</sup> Although the experts for both the taxpayers and the IRS agreed that the restrictions imposed by paragraphs 9.1–9.3 were reflective of an arm’s-length agreement, the IRS nevertheless asserted that the overall arrangement did not represent an arm’s length transaction.<sup>145</sup> Noting that the first two prongs had not been satisfied, the *Holman* court declined to address the taxpayers’ satisfaction of the third prong.<sup>146</sup>

#### D. Valuation Disregarding Paragraph 9.3 of the *Holman* FLP

Although the court’s application of section 2703 ignored any discounts arising from the restrictions under paragraph 9.3 of the *Holman*’s FLP agreement, the court was nevertheless required to determine the value of the partnership interests.<sup>147</sup> The starting point for a valuation assessment is the determination of the net asset value (NAV) of the partnership interests.<sup>148</sup> Because the *Holmans*’ partnership only contained shares of Dell stock, the value of those stocks on the dates on which the FLP interests were transferred would determine the applicable NAV.<sup>149</sup> Once the partnership’s NAV is calculated, the court will assess what, if any, discounts apply for lack of control and lack of marketability.<sup>150</sup> Further, when determining the value of property for federal gift tax purposes, the willing buyer approach is utilized.<sup>151</sup>

Under the *Holmans*’ FLP, a hypothetical buyer would have restricted control over his or her newly acquired asset because “such a buyer (1) would have no say in the partnership’s investment strategy, and (2) could not unilaterally recoup his investment by forcing the partnership either to redeem his unit or to undergo a complete liquidation.”<sup>152</sup> A hypothetical buyer in *Holman* would

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144. *Holman*, 130 T.C. at 197–98.

145. *Id.* at 198–99. When evaluating whether the structure of an FLP reflects an arm’s-length transaction, the applicable regulations provide a list of factors to consider, including “the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.” Treas. Reg. § 25.2703-1(b)(4)(i) (1992).

146. *Holman*, 130 T.C. at 199 (declining to decide whether the IRS correctly “appl[ie]d the arm’s-length standard . . . to the transaction as a whole”).

147. *Id.* The minority interest and lack of marketability discounts are still applicable to the *Holman* FLP, even after paragraph 9.3 is disregarded under section 2703(a) because other restrictions in the partnership agreement are still present and pertinent to the valuation determination of the limited partnership interests. *Id.*

148. *See id.*; *see also supra* note 25 (discussing the procedure for calculating net asset value).

149. *Holman*, 130 T.C. at 199.

150. *Id.*

151. Treas. Reg. § 25.2512-1 (1992); *see also* *Peracchio v. Comm’r*, 86 T.C.M. (CCH) 412, 414 (2003) (explaining that both the buyer and seller are hypothetical individuals who aim to achieve the maximum economic advantage).

152. *Holman*, 130 T.C. at 203.

then require a lower price “than the unit’s pro rata share of the partnership’s NAV” in order to offset the restrictions attached to the asset.<sup>153</sup> After each party’s expert testified, the court concluded that minority discounts should be allocated as follows: 11.32% for the 1999 gift, 14.34% for the 2000 gift, and 4.63% for the 2001 gift.<sup>154</sup> The court also found that a marketability discount was appropriate to account for the lack of a ready market for the limited partnership interests,<sup>155</sup> and valued that discount at 12.5%.<sup>156</sup>

Although the court found that discounts based on the restrictions enumerated in paragraph 9.3 were disallowed under section 2703(a), the court permitted the partnership to utilize other discounts when valuing the limited partnership interests.<sup>157</sup> Therefore, the IRS’s apparent success in applying section 2703(a) was limited by the finding that other discounts were allowed for the gifted partnership assets despite the applicability of section 2703(a).<sup>158</sup>

### *E. Future Use of FLPs*

The ambiguity in the *Holman* decision creates uncertainty about the impact it will have on future estate planning instruments. Because the failure to

153. *Id.* Under section 2703(a), the right or restriction being assessed for valuation purposes may be enumerated in the partnership instrument, or it may be implicit in the partnership’s capital structure. See Treas. Reg. § 25.2703-1(a)(3). For example, the IRS categorizes state law restrictions inhibiting a partner’s ability to withdraw or sell partnership interests as rights or restrictions implicit in the partnership’s arrangement. Bourland et al., *supra* note 22, at 468.

154. *Holman*, 130 T.C. at 207. The experts for both the taxpayer and the government agreed that the use of general equity funds was “reliable for [the] purposes of determining an appropriate minority discount.” *Id.* at 206. Although the experts used similar comparables, their treatment of outliers differed. *Id.* The taxpayers’ expert failed to account for outliers and used the median of each sample. *Id.* Conversely, the government’s expert accounted for outliers by calculating the mean, median, and interquartile mean. *Id.* The court adopted the analysis proffered by the government and refused to allow adjustments to the averages because the taxpayers’ expert failed to show that a “lack of portfolio diversity and professional management” would require further modification. *Id.* at 206–07.

155. *Id.* at 207. Both experts offered evidence from studies of marketability discounts in the context of restricted stock sales. *Id.* at 207–08. The experts both contended that “(1) no secondary market exists for LP units; (2) an LP unit cannot be marketed to the public or sold on a public exchange; and (3) an LP unit can be sold only in a private transaction.” *Id.* at 211. While the experts based their proposed discounts on similar groundwork, they failed to agree about the potential for a private market among the partners for limited partnership units. *Id.*

156. *Id.* at 215. The government’s expert successfully convinced the tax court that while a hypothetical buyer of a limited partnership unit would require a reduced price to compensate for market access, a holding period would not meaningfully diminish the cost. *Id.*

157. *Id.* at 215–16.

158. See Treas. Reg. § 25.2703-1(b)(5) (1992). When assessing whether a right or restriction satisfies the three-pronged test outlined in I.R.C. section 2703(b), each element is analyzed in isolation; therefore, the failure of one right or restriction to meet the requirements of section 2703(b) will not necessarily preclude another from being assessed in the valuation of limited partnership interests. *Id.* § 25.2703-1(b)(2). If, however, the failed right or restriction is integrally related to others included in the partnership’s instrument or structure, the rights that are related will be disallowed. *Id.* § 25.2703-1(b)(5).



satisfy any one prong of the section 2703(b) safe-harbor exception renders it inapplicable, the *Holman* court's analysis of the first two prongs is not instructive for future implementation.<sup>159</sup> The court's decision to analyze two prongs of the exception, when only the failure of one is required,<sup>160</sup> allows future taxpayers to argue that the *Holman* court's analysis of either prong should be considered dicta and, therefore, not binding.<sup>161</sup>

The ad hoc, fact-specific approach adopted by the judiciary when appraising limited partnership interests has not rendered a uniform set of valuation guidelines.<sup>162</sup> A lack of judicial guidance, coupled with the IRS's inability to pinpoint its statutory or theoretical basis for attacking any particular FLP before filing its deficiency notice, presents challenges to taxpayers using the FLP structure.<sup>163</sup> In the wake of *Holman*, consistency is needed so that a taxpayer may effectively organize assets while simultaneously complying with applicable tax and partnership law.

Although *Holman* may have left taxpayers with more questions than answers, it will not likely deter individuals from creating FLPs as a means to realize their estate planning objectives.<sup>164</sup> Despite the *Holman* FLP's

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159. See I.R.C. § 2703(b) (2006) (requiring that all three prongs be satisfied for the exception to apply).

160. *Holman*, 130 T.C. at 195–97. The tax court held, with regard to the first prong of section 2703(b), that there was not a bona fide business arrangement because the partnership failed to engage in activities other than the maintenance of its Dell stock. *Id.* at 195. Instead of ending its analysis here, the court proceeded to rule on the second prong of section 2703(b), concluding that paragraph 9.3 of the partnership instrument served as a device that transferred limited partnership interests for less than adequate consideration. *Id.* at 197.

161. See I.R.C. § 2703(b) (providing that section 2703(a) will not apply to any right or restriction that satisfies “each” of the three requirements under subsection (b)).

162. Brier & Darby, *supra* note 8, at 131. The judicial inconsistencies that arise from the heavy reliance on fact-specific inquiries are evident not only from the court's manner of analysis, but also in the bases adopted by the IRS when filing a notice of deficiency. See I.R.S. Field Serv. Mem. 2001-43-004 (Nov. 5, 2001), *reprinted in* 15 TAX ANALYSTS 5686, 5689 (2001) (emphasizing the importance of an individual case's facts in determining which arguments the IRS should advance).

163. See *Peracchio v. Comm'r*, 86 T.C.M. (CCH) 412, 414 (2003) (noting that the IRS filed a notice of deficiency that stated four bases for attacking the FLP, although the IRS ultimately advanced only one of their originally stated arguments). Additionally, courts have recognized that the IRS often provides a “grossly exaggerated amount asserted in the notice of deficiency.” *Succession of McCord v. Comm'r*, 461 F.3d 614, 625 n.22 (5th Cir. 2006). In *McCord*, the Commissioner's own expert calculated the aggregate fair market value of all disputed gifts to be \$1,735,879 less than the initial amount stated in the IRS's notice of deficiency. *Id.* The court generally grants the IRS a presumption of accuracy when evaluating a notice of deficiency; therefore, the taxpayers have the burden of proving the deficiency calculations erroneous. See *Estate of Kelley v. Comm'r*, 90 T.C.M. (CCH) 369, 370 (2005).

164. See generally Lurie & Schuck, *supra* note 9 (discussing considerations of estate planning). Attempts by the IRS to control the use of FLPs in an estate planning context have been met with fervent opposition. *Id.* at 251. In 1994, the IRS proposed regulations to accompany section 701 of the IRC; included in the proposal were two examples that sought to further regulate FLPs by (1) finding it unfair to fund an FLP using a principal residence; and (2)

articulated purpose, the nature of property rights changes when assets are placed in a limited partnership.<sup>165</sup> For this reason, the word discount “should not be viewed as automatically synonymous with an artificial and undeserved tax benefit.”<sup>166</sup> The IRS has aggressively attempted to minimize the valuation discounts afforded under limited partnerships;<sup>167</sup> however, its prior efforts to eradicate them wholly or partially have been mostly ineffective.<sup>168</sup> To meet the requirements for the application of section 2703(b), estate planners should make efforts to both supply a legitimate business purpose when forming an FLP and craft restrictions that would be similar to those found in an arm’s-length transaction.<sup>169</sup>

#### IV. CONCLUSION

Incorporating FLPs into an estate planning scheme can provide numerous gift and estate tax benefits that would not otherwise be realized. Tax advantages associated with the FLP are mainly obtained through discounts

requiring a delay after the partnership’s establishment before gifts could be made. *Id.* Despite these efforts, the examples were ultimately removed due to the overwhelming condemnation that they received. *Id.*

165. See Brier & Darby, *supra* note 8, at 129 (noting the disparity in valuations of property rights before and after the rights transfer into a partnership entity).

166. *Id.*

167. See Tom Herman, *Uncollected Taxes Reach \$290 Billion: New Government Estimates Likely Will Pressure IRS to Step Up Enforcement*, WALL ST. J., Feb. 15, 2006, at D4. IRS Commissioner Mark E. Everson stated that “[t]he magnitude of the tax gap highlights the critical role of enforcement in keeping our system of tax administration healthy.” *Id.* The tax gap is a methodology that the IRS uses to assess “the difference between what taxpayers should pay and what they actually pay on a timely basis.” INTERNAL REVENUE SERV., New IRS Study Provides Preliminary Tax Gap Estimate, Mar. 29, 2005, <http://www.irs.gov/newsroom/article/0,,id=137247,00.html> (last visited Oct. 26, 2009). The tax gap is organized into three parts: “underreporting of income, underpayment of taxes[,] and non-filing of returns.” *Id.* While the IRS has made estimates concerning the tax gap for individuals, it seeks to conduct similar research concerning flow-through entities, such as partnerships. *Id.* Estimates have not yet been formulated concerning partnerships; however, the IRS has established that the reporting of deductions has been an area in which taxpayer compliance has deteriorated. *Id.*

168. See, e.g., H.R. REP. NO. 106-658, § 6, at 7-8 (2000) (discussing proposed legislation aimed at eliminating valuation discounts). Proposed legislation during the Clinton Administration failed to abolish valuation discounts for non-business assets in limited liability entities. *Id.* Although FLPs have been difficult to undermine completely, the IRS has succeeded in reducing valuation discounts either statutorily—using section 2036(a)—or by challenging the taxpayers’ appraisals of their limited partnership interests. See, e.g., *Estate of Thompson v. Comm’r*, 382 F.3d 367, 369 (3d Cir. 2004) (finding that section 2036(a) applied and recaptured the assets from the FLPs to include them in the decedent’s gross estate); *Kelley*, 90 T.C.M. (CCH) at 373 (minimizing the minority status and lack of marketability discounts applied by providing alternate calculations to those offered by the estate).

169. Bourland et al., *supra* note 22, at 468. Examples of restrictions that are consistent with a third-party arrangement include “a right of first refusal, limitations on the ability to pledge partnership interests for third party debt, and provisions for a buyout of a partner’s interest upon a default under the terms of the partnership agreement.” *Id.*

attributed to minority status and a lack of marketability. Although the IRS has aggressively sought to undermine the FLP structure and minimize the valuation discounts afforded for limited partnership interests, its success has been minimal. Section 2036(a) and expert appraisals are the most effective means for the IRS to combat valuation discounts.<sup>170</sup> Section 2703(a) may be used to disregard restrictions when appraising partnership interests; however, each right or restriction is viewed in isolation. Therefore, when a particular restriction fails to meet the three-pronged exception under section 2703(b), it does not necessarily preclude other rights or restrictions from being included in the valuation assessment of partnership interests. Although *Holman* provided the IRS an additional statutory approach to reduce valuation discounts, it will not likely deter taxpayers from using FLPs because considerable discounts are still applicable.

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170. See I.R.C. § 2036(a) (2006); see also Bourland et al, *supra* note 22, at 493 (explaining the operation of section 2036(a)); *Kelley*, 90 T.C.M. (CCH) at 371 (examining the role of expert testimony in determining what, if any, valuation discounts apply to restricted FLP interests).